

INDIAN CURRENCY AND EXCHANGE

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PREFACE

THIS book on Indian Exchange and Currency is based on lectures delivered from 1920 to 1922 at the Central Hindu College, Benares, and the Elphinstone College, Bombay. The audiences consisted of students preparing for the degree courses in Economics.

Part I of this book is intended for candidates preparing for the pass degree in Economics, whose knowledge of general principles of Currency and Exchange is usually limited to the contents of an elementary book on Economics, such as Gide's *Political Economy*. An attempt has been made to incorporate in this part the new explanations of Exchange movements, associated with the names of Mr. Keynes, Prof. Cassel and Prof. Pigou, and bring the theory up to the stage where it can afford adequate explanation of the movements of Indian Exchange. Though intended primarily for candidates for a degree in Economics, this part has been put into a form that will be comprehensible to an intelligent person of average education who has had no previous training in Economics.

Part II of the book is mainly critical, and embodies the main conclusions of the author. It is meant primarily for the candidates for the Honours degree, but will, it is hoped, prove useful to the publicist who is anxious to follow intelligently the numerous controversies on our Currency System.

The obligations of the author to existing works are numerous, and have been acknowledged, wherever possible, either in the body of the book or in the foot-notes. In particular, it is evident that in dealing with Foreign Exchanges no text-book writer can ever escape heavy obligations to the well-known works of Goschen, Prof. Marshall, Mr. Hartley Withers, Mr. Keynes, Prof. Cassel, and Prof. Kemmerer.

The short bibliography appended will, it is believed, prove of assistance to students.

H. L. CHABLANI.

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CHAPTER I

THE INDIAN RUPEE

1. In the civilized life of the present day, human beings satisfy their economic needs by means of a complex organization, based on division of labour and exchange of commodities and services. They do not, however, exchange *directly* what they do not want for that which they want; they carry on their business of exchange through an 'interposed commodity,' called money. They do not barter one commodity for another; they *buy* and *sell* commodities with 'money.' The reason why they resort to this course lies in what Jevons calls 'want of coincidence in barter.' The difficulty in barter is 'to find two persons whose disposable possessions mutually suit each other's wants. There may be many persons wanting, and many possessing those things wanted; but to allow of an act of barter, there must be a *double coincidence*, which will rarely happen.' These inconveniences have been avoided in civilized life by the use of some universally acceptable commodity as a *medium of exchange*—a commodity which 'every one shall receive in exchange for what he has but does not desire personally to consume, in the confident assurance that with it he can, at any time, and of kinds and in quantities to suit his immediate wants, obtain from others what they have but do not desire to use.'¹

A medium of exchange once adopted can serve, and does serve, another purpose, that of a common *measure of value*, in terms of which the value of all other things is obtained; for, as Mill tells us, 'it is easier to ascertain and remember the relations of many things to one thing, than their innumerable cross-relations with one another.'

If the commodity chosen as 'money' is not liable to decay or to vary much in value, it becomes useful for the purpose of expressing pretty accurately the relations of debtors with creditors to the satisfaction of both parties. In other words, it will perform the function of a *standard for deferred payments*.

¹ F. W. Walker.

Now it is quite possible to employ one substance as a medium of exchange, a second as a measure of value, and a third as a standard for deferred payments. But it is certainly more convenient to select one single substance which can serve all these functions. Such a commodity is called 'money.'

Obviously, no commodity can perform these functions satisfactorily, unless it is universally acceptable. The force of law or social convention can make *anything* universally acceptable for a time. But the only sure basis of general acceptability for *long periods* and up to almost *unlimited* extent lies in the intrinsic value of a commodity as a commodity, apart from its legal or conventional value. Hence the phrase 'true money', so commonly used to signify the quality possessed by a standard of value, whose market value as a commodity equals its value as fixed by law.

This would be the case in all countries, where the mints are 'open to free coinage' of silver or gold. In such countries, Government fixes a certain price which it is willing to pay for gold or silver of a certain standard, and undertakes to coin practically free of charge any quantity of bullion that the public may bring to the mint at a certain fixed number for a specified weight of the particular metal. In such circumstances, the value of the metallic coin can rarely (and then, too, for only a short period) exceed the market value of the metal as a commodity, for people can easily convert bullion into coin if there be any appreciable difference between the two. Nor can the value of the metallic unit of currency fall below its value as bullion in the market, for it can easily be *melted* into bullion and sold as such.

Such a standard coin, freely minted, is easily accepted by people in the transactions of everyday life up to unlimited amounts; and though the laws of these countries declare formally that such a coin is unlimited legal tender, acceptable by the public in payment of debt, no compelling power of the law is really necessary to make it acceptable to the public *in fact*.

In most countries, however, certain coins are freely in circulation, whose denomination is not really in accord with the value of their material or weight. They are generally intended to satisfy the need of the public for some medium of exchange and measure of value in transactions of small value, and are,

therefore, generally *limited* legal tender. For example, the English shilling is by law equivalent to one-twentieth part of a sovereign, though the silver in it would fetch much less than this in the bullion market. It is legal tender up to forty shillings only. Such a coin is generally known as a 'token coin.'

2. It is easy to see which of these propositions are applicable to the Indian rupee. It performs all the functions of money. It is the principal medium of exchange and measure of value in India; and it does serve as a store of value and a standard for deferred payments. But it is not what is popularly called 'true' or 'natural money.' Its value as a coin is much above its value as silver, and it is, in this respect, in the same position as the English shilling. But unlike the latter, it is *unlimited legal tender* and fulfils largely the other requirements of 'standard' money.

In the numerous polemics on Indian currency, the Indian rupee is freely called 'a token coin.' That statement is true in a sense, if properly understood; but it is likely to mislead the unwary reader into thinking that the rupee in India resembles the English shilling more than it resembles the English pound. As a matter of fact, this token rupee is *the standard* money in India, for 'as long as the *main* currency is in rupees, all contracts are made and taxes calculated in rupees, all transactions effected in rupees, and rupees are legal tender to any amount, *the rupee is really the standard.*'¹ If then the rupee is still called a 'token coin', it must be remembered that it is a *token currency of a peculiar kind*—a token currency which is more widely used than the nominal standard, a token currency which is unlimited legal tender and the chief measure of value in India. It may be called 'a standard token coin', if such an expression be permissible.

It must be clear at this stage that the value of the rupee could not exceed appreciably the value of its silver contents, as long as the Indian mints were open to the 'free coinage' of silver. This was the case till 1893. During this period of 'open mints', the value of the rupee was 'natural', and not 'artificial', determined by the market price of silver, and not by any Government fiat or manipulation. Under the conditions then existing,

¹ Sir Samuel Montagu's evidence before the Chamberlain Commission.

the expansion and contraction of the rupee circulation was perfectly automatic, regulated by the conditions of trade and commerce, internal as well as external. If business was brisk and harvests were abundant, the public could easily increase the amount of rupee circulation by converting silver into rupees at the Indian mints. If trade was slack, the business community depressed, and rupees in circulation redundant, the public melted rupees into silver and thus effected a contraction of circulation. Government, as government, had practically no control over the expansion or contraction of currency.

Things, however, became different after the *closing* of the mints in 1893. The Government of India then assumed charge of the work of adjusting the volume of India's currency to the ever-varying requirements of its business and trade. Ever since then, Government has been creating as much or as little of the standard token money of the country as it thought was justified by certain indications of an elaborate mechanism, the details of which we shall examine later on. Whether the system devised by Government resulted in a natural or automatic expansion and contraction of our currency, as is claimed by the official exponents of the system, or whether it left everything to the caprice of Government, as is alleged by its critics, is a question which will be discussed later on. The point to note at this stage is the establishment of a *Government monopoly* in the supply of currency. The closing of the mints prevented private individuals from establishing equilibrium between the value of the rupee and the value of its silver contents. Thereafter, the value of the rupee was completely divorced from that of the silver in the rupee. The rupee, as already remarked, became a standard token money.

3. Something still remains to be said if the position of the rupee in India is to be properly understood. The rupee is not the only unlimited legal tender in India. The British sovereign, too, shares that honour; and the law of the country fixed its value at fifteen rupees before 1919, and at ten rupees thereafter, in theory at least.

Since the value of the rupee was a fixed fraction of the British sovereign, the pre-war Indian currency system was sometimes

described as a 'gold standard.' Now this phrase, so often heard in these days, is a slippery one: it is not always used in the same sense. But in spite of a variety of meanings attached to it, almost everybody is agreed that pre-war England had a *gold standard in every respect*. It had a standard money, made of gold; all other kinds of money in use in England were ultimately convertible into gold money; and its gold money was itself convertible, by melting or export, into *ordinary gold bullion*. Judged by these three tests, India was not 'on a gold standard' in pre-war days. The Indian rupee was convertible into gold only on those special occasions when Government offered gold in *London* in exchange for rupees in *India*.

Was the Indian standard then bimetallic? Now, a pure and simple double standard or bimetallism implies two essential elements. Under it, all coins, whether of silver or gold, are made unlimited legal tender for the payment of debts; this, no doubt, was the case in India also. But more important than this is the essential condition that under bimetallism both metals are *freely minted*; this was just the opposite of the conditions obtaining in India. Thus, of the two essentials of a double standard—free coinage and full legal tender—the Indian currency system lacked one.

Some writers, therefore, called the pre-war Indian currency system 'a limping bimetallism', a name commonly applied to the pre-war monetary system of France, on the ground that under it 'the silver coin, though intrinsically of less value than the gold, hobbles along, maintained at equality by being coupled with its stronger associate.'¹ This, however, was not the only point of resemblance between the two. In both the countries, mints were closed to free coinage of silver; in both, silver coins were unlimited legal tender; in neither were silver coins legally convertible into gold; and both depended for their external trade on gold, the international medium of exchange. But here the resemblance between the two ends. In France, silver coinage, except of subsidiary coins, was completely stopped; in India, the coinage of silver rupees was resumed in 1900, and silver continued to be minted more and not less extensively than before. In France the mints were open to free coinage of gold, and large

¹ F. W. Taussig.

quantities of gold were not only put into active circulation but also held in reserves ; India had neither a gold mint, nor much of gold in circulation or in its local reserves. In France there was no undertaking on the part of government to redeem its silver coinage in gold either inside the country or abroad ; the Government of India, on the other hand, adopted in practice a system of partial redemption, issuing orders, so to speak, for the delivery of gold from its gold reserves or other gold assets held in London.

Some other name was therefore needed to describe the pre-war Indian currency system properly ; and the label most commonly applied to it was the ' gold-exchange standard. ' There was considerable justification for this practice. For internal purposes, the rupee was the medium of exchange and measure of value ; for external purposes the British sovereign was the effective standard ; and the *exchange* value of the rupee in terms of the British sovereign was an *almost* fixed fraction of the latter. But even this description is not an accurately correct statement of pre-war conditions. As Sir Lionel Abraham pointed out in his evidence before the Chamberlain Commission, the Indian system was *something more than* the gold-exchange system. ' The ideal gold exchange system would be a system under which there were central stocks of gold under the management either of the Government or of a responsible central bank with little or no gold in circulation ' ; but the Indian system during the period 1893-1916 was different from that in so far as it sometimes encouraged a certain circulation of gold. ' It was on its way towards becoming a combination of a gold exchange system and a gold currency system. '

What about the Indian currency system after the war ? It is difficult to characterise it by a single epithet applicable to all the phases through which the Indian currency system has passed since the war. At one period, the Indian rupee was linked to the English sterling, which was then different from the gold contents of the sovereign ; and thus the Indian system was more a sterling-exchange than a gold-exchange system. At another period, the rupee was made to follow the rising price of silver, and its value then was very nearly the value it would have had under the open-mint system. It was then fast drifting to a silver standard. At a third period, an attempt was made to fix the

value of the rupee in terms of gold at the rate of 2s. gold to one rupee, and so the Indian system was practically a dollar-exchange system, for the American dollar was then the only metallic standard the value of which was determined by natural automatic conditions. The attempt failed; and ever since that failure Government profess to have allowed the rupee to find its own level, unaided or unhindered by any action on their part. So the rupee now is practically in the position of an inconvertible note printed on silver.

CHAPTER II

THE THEORY OF MONEY

1. As shown in the preceding chapter, the value of the rupee under 'Free Mints' was natural and not artificial, determined by the market value of silver and not by the compelling power of law. No human authority could give the rupee a value higher than that of its silver contents so long as the mints were open to the free coinage of silver. If the gold price of silver declined, so did the gold value of the rupee. Owing to various reasons which we shall have occasion to examine in a subsequent chapter, Government considered this state of things very undesirable, and therefore decided to close the mints in 1893, with a view to divorce the gold value of the rupee from that of its silver contents. It was hoped that it would be possible by this means to give the rupee an artificial value, higher than its intrinsic value.

Was it in the power of Government to do so? It is not in the power of any government to fix the exchange value of, say, wheat, cotton, etc., etc. How then was it thought possible for the Indian Government to regulate the gold value of the rupee? Those who believed in this possibility rested their whole case on what was known as the 'Quantity Theory' of money. If Government could only *limit* the issue of rupees, they would succeed in raising the value of the unit of money; for the value of money, according to this school, depended on its *quantity*. This 'Quantity Theory' has been one of the most bitterly contested theories in economics. It has been vehemently denied by some economists; it has been emphatically re-asserted by others. Often, it has been erroneously stated. It is necessary therefore to give a brief outline of this theory, as stated by some of its best exponents.

2. In its simplest form, the theory enunciates an almost self-evident proposition. In a community in which almost all things that are produced are bought and sold, in which

there is neither much of barter nor much of hoarding, in which *all* the metallic money, gold or silver, passes from hand to hand at every purchase, in which each unit of money circulates only once, credit in any of its shapes being unknown, the *quantity* of metallic money determines the *purchasing power* of the monetary unit, if the total volume of exchange-work or the volume of business transactions carried on with the aid of money remains the same. If fewer units of money were available, there would be more work for each of them to do ; each of them would have to exchange for a larger volume of other things ; the purchasing power of each would be greater than before. If more units of money were available, each would have to exchange for a smaller volume of other things ; its value or purchasing power would be less than before. In other words, if P denotes the purchasing power of the monetary unit, T the volume of exchange-work in the community, and M the number of monetary units, the purchasing power of the unit will be the same as the quantity of work done by one unit ; and so we have the equation $P = \frac{T}{M}$. The value of money (i.e. its purchasing power)

thus *varies inversely* as its quantity. If the quantity of money is increased, the purchasing power of the unit will fall, or, what comes to the same thing, *the price level will rise* ; and if, on the other hand, the quantity of money is decreased, the purchasing power of money will rise, or, what comes to the same thing, the price level *will fall exactly in proportion to the increase*.

In the complex world of to-day, however, conditions are different ; and we must now make allowance for all the possible influences that go to modify the effect of the quantity of metallic money.

In the first place, metallic coins are not the only media of exchange. Cheques, and bank or currency notes serve the same purpose as metallic money, and therefore affect prices as well as specie would. The total volume of currency in a country thus includes (a) the quantity of metallic currency in circulation ; (b) the amount of bank deposits against which cheques may be drawn ; and (c) the number of currency notes in circulation. In the second place, ' the effective currency of the country depends upon the *quickness of circulation*, and the number of exchanges

performed in a given time, as well as upon its numerical amount ; and all the circumstances, which have a tendency to quicken or to retard the rate of circulation, render the same amount of currency more or less adequate to the wants of trade.' ¹ If a coin circulates three times instead of once, it performs the exchange-work which three coins did before. An increase in the rapidity or velocity of circulation of currency is thus equivalent to an increase in its quantity.

We must therefore amend our formula $P = \frac{T}{M}$ into the equation $P = \frac{T}{MV + M'V'}$ where M is the quantity of money (including currency notes) in circulation, V its 'efficiency' or 'velocity' of circulation (or the average number of times a year money is exchanged for goods), M' the total bank deposits subject to transfer by cheque, V' the velocity of circulation of the latter, and T the volume of trade (or amount of goods bought with money).

As thus stated, the quantity theory does not justify the idea that if the quantity of metallic money is doubled, prices would *always* be doubled. It may be that there is a simultaneous change in all the five influences ; the price-level will then be a compound or resultant of these various influences. All that the theory asserts is that, if *other things remain the same*, an increase in the *quantity* of money will increase prices in the *same proportion*.

It is necessary for the reader to bear in mind the many qualifications covered by the economist's favourite phrase 'other things being equal.' The changes in these other things are sometimes more important than the changes in the volume of precious metals. 'There may be a change in the volume of things on sale : there may be an increase or diminution in the average number of times each of these things changes hands during the year, or in the average number of times each coin or each element of the currency changes hands during the year : there may be a change in the methods of business or in the ratio between cash and the demand deposits of the bankers. Thus the phrase "other things being equal" covers so much ground, is so extensive a qualification of the general rule, that one has to

¹ Bullion Committee's Report of 1810.

recognize the possibility of a great rise of prices without a change in the supplies of gold and silver.' ¹

3. In this form the doctrine is almost a truism, 'for, if one column of a ledger recorded accurately all the transactions for money in a year with their values; while another column specified the number of the units of money employed in each transaction; then the two columns when added up would balance. The second column of course would represent the aggregate value of the total number of changes of ownership of all the units of money: and that is the same thing in other words as the total value of the money multiplied by the average changes of ownership (otherwise than by free gift, theft, etc.) of each unit.' ²

But the upholders of the quantity theory believe it to be true in a *causal* sense. They assert that one of the *normal* effects of an increase in the quantity of money is an exactly proportional increase in the general level of prices. For according to them the effect of doubling money in circulation (*M*) is normally to double deposits 'because under any given conditions of industry and civilization deposits tend to hold a *fixed or normal ratio* to money in circulation. Hence the ultimate effect of a doubling in *M* is the same as that of doubling both *M* and *M'*.' Neither the velocity of circulation which depends on density of population, commercial customs, rapidity of transport, and other technical conditions, nor the value of the trade which depends on natural resources and technical conditions, will be affected in any way by this increase in the quantity of money. So far, therefore, as *M* by itself is concerned, its effect on the price-level is *strictly proportional*.³

It must not be supposed that the believer in this theory of money denies that there are other causes, not included in this equation of exchange, which can and do influence the purchasing power of money. For instance, Prof. Fisher, the best exponent of this theory admits that the five causes are themselves the effects of many antecedent causes, some of which he summarises as follows: 'The volume of trade will be increased, and

¹ Marshall in his evidence before the Fowler Commission.

² Marshall.

³ For qualifications to this doctrine see Keynes' 'Tract on 'Monetary Reform', pp. 79-83.

therefore the price level correspondingly decreased by the differentiation of human wants ; by diversification of industry ; and by facility of transportation. The velocity of circulation will be increased, and therefore also the price level increased by improvident habits ; by the use of book credit ; and by rapid transportation. The quantity of money will be increased, and therefore the price level increased correspondingly by the import or minting of money, and antecedently, by the mining of the money metal ; by the introduction of another and initially cheaper money metal through bimetallism ; and by the issue of bank notes and other paper money. The quantity of deposits will be increased, and therefore the price level increased, by extension of the banking system and by the use of book credit. The reverse causes produce, of course, reverse effects. ' What the believer in this theory of money asserts is that these are the *five proximate causes through which all others whatsoever must operate*.

Some of the exponents of the theory further maintain that all the factors included in this equation of exchange are not equally important. They contend that among these, the quantity of specie is, in normal times, the most important ; and that the older economists were right in emphasizing its fundamental importance. The rapidity of circulation of goods is fairly constant in a given community. The velocities of circulation of metallic and non-metallic media of exchange, depending as they do on the habits of the individual and the system of payments in the community on the one hand, and on such general causes as density of population and rapidity of transportation on the other hand, change in normal times so slowly and to such a small extent, as to be almost negligible factors in raising the price level. The use of precious metals in the arts, though influenced to a certain degree by the value of monetary supply, is in the main influenced by changes in the habits and tastes of people ; and these are not changed easily, quickly, or appreciably. One is therefore justified in saying that if the total amount of specie is increased, the proportion of it used in making purchases at a given time will be correspondingly increased. Both paper currency and cheques are in normal times usually convertible into metallic coins ; and both have therefore the backing of metallic reserves behind them. The ratio of the metallic reserves to the non-metallic media of exchange is not the same everywhere, nor

is it unalterable in the same country. But it is more or less a definite one for each well-ordered community in normal times during periods which are not long enough to bring about revolutionary changes in the monetary habits of the people.

Such in brief outline is the modern form of the theory of money, belief in the truth of which inspired the monetary changes of 1893. Their real author, Sir David Barbour, states in his *Standard of Value* that he was 'firmly convinced of the soundness of the quantity theory of money, and knew that if the unlimited coinage of silver was stopped, it was quite possible to reduce the amount of the rupee circulation to such an extent as to bring the Indian exchange to a *par* with gold at a rate of exchange which could be permanently maintained.' In the peculiar conditions then existing in India, he had considerable justification for the view that the *purchasing power* depended almost *exclusively* on the quantity of rupees in circulation, for the note circulation then was insignificant, and cheques were almost unknown except to a very limited extent in the Presidency towns. He assumed, and assumed wrongly, as we shall have occasion to show later on, that a rise in the internal purchasing power of the rupee in terms of commodities *would necessarily* bring about a rise in the *external* value of the rupee in terms of the English sovereign or gold. Be that as it may, however, the quantity theory of money on which Sir David Barbour relied neither proves nor disproves this supposed necessary connection between the *exchange value* of the rupee in terms of *gold* and its internal *purchasing power* in terms of *commodities*. The quantity theory of money deals with the latter and has nothing to say about the former. The distinction between the two is an important one; and the reader must be carefully on guard against the common fallacy of mixing up the two different meanings of the phrase 'the value of the rupee.'

4. At the present time, however, ^{the purchasing power of the rupee is not the same as it was in 1893} conditions are not so simple as they were in 1893. Since then there has been a great improvement in banking and monetary facilities. Leaving out of account the increase in the amount of deposits with the Indian shroffs, for which it is very difficult to get any accurate figures, there has been a phenomenal growth in the amount of deposits (the potential currency in the hands of the public) with the Presidency Banks, the Exchange Banks and the Indian Joint Stock Banks.

The following table brings out the great contrast between the earlier years and the later period :—

Bank Deposits (on 31st December each year in Rs. 1,000).

Year	Presidency Banks and branches—deposits	Exchange Banks		Indian Joint Stock Banks with Capital and Reserve of 5 lakhs and over	
		Deposits (Indian only)	Number	Deposits	Number
1890	18,35,60	7,53,60	5	2,70,78	5
1900	15,68,80	10,50,35	8	8,07,52	9
1910	36,58,01	24,79,17	11	25,65,85	16
1911	38,58,29	28,16,00	12	25,29,11	18
1912	40,11,48	29,53,62	12	27,25,98	18
1913	42,37,16	31,03,54	12	22,59,19	18
1914	45,65,60	30,14,76	11	17,10,58	17
1915	43,49,86	33,54,56	11	17,87,27	20
1916	49,91,45	38,03,88	10	24,71,05	20
1917	75,43,02	53,37,53	9	31,17,01	18
1918	59,62,03	61,85,60	10	40,59,48	19
1919	75,93,61	74,35,90	11	58,99,47	18
1920	87,04,53	74,80,71	15	71,14,64	25
1921	72,58,00	75,19,61	17	76,89,63	27
1922	71,16,30	73,38,44	18	65,01,75	27

The amount of cheques cleared at the clearing houses in the great trade centres tells the same tale, as is shown by the following table :—

Years	(In crores of rupees)				
	Total—Calcutta, Bombay and Madras, till 1901 and Karachi since 1901, + Rangoon since 1910—Cawnpore since July 1920, + Lahore since April 1921.				
1893	146
1894	158
1895	175
1896	181
1897	190
1898	176
1899	202
1900	212
1901	213
1902	232
1903	247
1904	255
1905	303
1906	335
1907	372

Years					
	(In crores of rupees) Total-Calcutta, -Bombay and Madras, till 1901 and Karachi since 1901, + Ran- goon since 1910—Cawn- pore since July 1920, + Lahore since April 1921.				
1908	363
1909	368
1910	465
1911	516
1912	587
1913	650
1914	538
1915	563
1916	809
1917	901
1918	13,96
1919	18,06
1920	31,49
1921	20,22
1922	20,23
1923	18,03

The increase in note circulation has been still more surprising. But before dealing with this aspect of the matter, we have to notice in some detail the principles and history of the Indian Paper Currency system.

CHAPTER III

THE INDIAN PAPER CURRENCY SYSTEM

1. The history of the Indian Paper Currency system falls into three distinct periods. The dividing point between the first and the second period is the year 1861, and that between the second and the third, the year 1919. Prior to 1861 note-issue was not a Government function; it was an affair of certain private banks. During the second period, 1861-1919, Government took over the function of issuing notes, and modelled the Indian Paper Currency system on what are known as the principles of the English Bank Charter Act of 1844. In the period since 1919, various modifications have been introduced into the system with the view to remedy what appeared to be its defects in the light of the experience of other countries.

2. The first period may be dismissed in a few words. There was then no Government issue of currency notes; only a few private banks issued them. The circulation of these notes was practically confined to the cities of Calcutta, Bombay and Madras; and they were not legal tender in any part of the country. The three Presidency banks were the most important of these note-issuing banks; and their maximum authorized issue was only five crores of rupees, against which one-fourth was to be held in specie.

3. The second period opens with Act XIX of 1861, which deprived all private banks of their right of note-issue and based the Indian Paper Currency system avowedly on the principles of the English Bank Charter Act of 1844. It established a Government monopoly of note-issue, and created a Paper Currency Department through which Government was to issue notes of various denominations in the form of promissory notes payable to bearer on demand. It divided India into certain circles, each containing one city to be the place of issue of the notes of that circle. It empowered Government to issue notes without limit at any paper currency office against rupees or gold. Until 1910 these notes were legal tender only within the circle of issue and could be encashed as of right only at the head office of that circle. It placed a limit of four crores on the fiduciary issue (or

the amount of notes issued against securities) and imposed on Government a legal obligation to keep a metallic reserve in silver coin or bullion against the *whole* of the notes issued beyond that amount. It was dominated by the idea that 'the sound principle for regulating the issue of paper circulation is that which was enforced on the Bank of England by the Act of 1844, i.e., that the amount of notes issued on Government securities should be maintained at a fixed sum, within the limit of the smallest amount which experience has proved to be necessary for the monetary transactions of the country, and that any further amount of notes should be issued in coin or bullion, and should vary with the amount of the reserve of specie in the bank, according to the wants and demands of the public.' (Para. 13, Government of India's *Despatch*, dated March 26, 1860.)

The object of these provisions was to prevent the issue of notes in excess of public requirements; for an over-issue of currency was regarded as a serious evil. It caused prices to rise, and inflicted unmerited injury on people with fixed incomes, who found the purchasing power of their money much less than before. The only way to prevent this evil was to make the notes *convertible* into metal and to insist on providing adequate metallic reserves behind them. So long as a note-issuing authority had to provide large amounts of specie in reserve, it had very little temptation to over-issue notes. Even if it did, the public was likely to present them back for encashment and so curtail their circulation in excess of public requirements. The authors of the Bank Charter Act, however, went much farther than this. They aimed at *ideal safety*. They provided not only for *convertibility* of paper currency but also for its almost *absolute identity with the metallic circulation that it displaced*. In other words, all paper issues beyond a fixed sum were, under their system, to represent actual coin or bullion in the reserve. The Indian Act of 1861 was based on the same ideas; it too made the notes practically bullion certificates, for the rupee then was a freely minted coin worth no more than its silver content.

The system, however, was not free from defects. The limitation of the *areas* of legal tender and of the offices where the notes were encashable on demand restricted the growth in the

popularity of notes. Government gained nothing by the issue of notes, as the currency offices had to keep in reserve an equivalent amount in coin or bullion; and so notes were *no more economical* than rupees. And during those times when, owing to the briskness of trade, the business community needed more currency, Government's *power to expand* note-issue was no greater than its power to mint more rupees. The system, in short, lacked one of the essential requirements of a good currency system, namely, *elasticity*. It provided for absolute security for encashment of notes; but that almost ideal and to a large extent unnecessary safety was more than counterbalanced by the disadvantages from inelasticity and want of economy. The *English* system, which it sought to imitate, escaped the inconvenience from inelasticity by the development of the cheque system in English banking, which provided the business community in England with an ideal elastic currency, expanding and contracting in circulation automatically with the requirements of the situation. Foreign countries met their needs by trying all kinds of new principles for the regulation of their note-issue, attempting all sorts of compromises or half-way houses between absolute security and ideal elasticity. *India* had neither an elastic note-issue nor an elastic cheque currency. It had only an *inelastic note-issue*.

The truth of the matter was, that the Indian administrators had copied the English system without taking sufficient account of the differences between the conditions in England and in India. And England, as Prof. Marshall pointed out in his cross-examination by the Fowler Committee, was a specially bad example for India to follow in matters of currency. 'For, first, currency is but a small part of the means of payment used in England; and under most, though not all, conditions, bank money is the main means of payment; and that is elastic. Secondly, an imperative demand for increased currency is rare in England; and when it does occur, it is on a very small scale relatively to England's total business and resources. . . . Thirdly, England is near to other great gold markets. Fourthly, her financial houses are numerous and able . . . England's banking system is very highly organized, specially by the aid of the branch banks. . . . Partly for this reason, currency drawn from London in the spring or autumn completes its circuit more

quickly than in Germany ; and of course much more quickly than in India.' ¹

4. The closing of the mints in 1893 led indirectly to some *relaxation of this rigidity* of the Indian Paper Currency System. The rupee became an artificially valued coin, worth more than the silver it contained, by the year 1898 ; but under the terms of the law governing the Indian Paper Currency System, it continued to be a legitimate form of the Indian Paper Currency Reserve. A 10-rupee note could thus be issued by buying silver worth even less than six rupees, coining it into ten rupees, and keeping the latter in the Paper Currency Reserve as the necessary metallic basis under the law. The system thus acquired through inadvertence a certain degree of elasticity and economy owing to a change in the character of the rupee.

5. Various other minor changes in the system established in 1861 were brought about by successive enactments during the period 1861-1913.

(1) The amount to be invested or the fiduciary portion of the note-issue was increased from time to time, to six crores in 1871, eight in 1890, ten in 1896, twelve in 1905 (of which two crores might be securities of the United Kingdom), and fourteen in 1911 (of which four crores might be securities of the United Kingdom), so that the composition of the Indian Paper Currency Reserve on March 31, 1913, was as follows :—

Total circulation	Silver in India	Gold in India	Gold in London	Securities	
				Sterling	Rupee
68·97 crores ...	16·45	29·37	9·15	4	10

In spite, however, of this increase in the amount of the invested portion, the *securities in 1913 constituted a much lower percentage of the whole Reserve* than in the preceding years owing to the much larger growth in circulation, the figures at the end of the year in which the successive additions to the securities were made being—1871-72, 44·9 per cent ; 1890-91, 27·2 per cent ; 1896-97, 42·1 per cent ; 1905, 26·9 per cent ; 1911-12, 22·8 per cent.

¹ Q 11776, Fowler Committee's Report.

(2) Up to 1893, the whole of the Paper Currency Reserve was held in silver coin; but in that year, the executive was authorised by law to issue notes in exchange for gold coin or bullion to any amount. In 1898, Government kept a portion of *this gold in London* under temporary authority. This became a part of a permanent policy under Acts IX of 1902 and III of 1905, which permitted Government to hold the reserve in rupees, gold coin, bullion, or securities either in India or in London, subject only to the exception that *all coined rupees were to be kept in India*, and not in London. The primary object of the reserve was to ensure the encashment of notes into rupees; and the only justification at first for transferring part of the reserve to London was to *provide means for purchasing* silver to be minted into rupees for the Paper Currency Reserve in India. But experience soon showed that this part of the reserve which was transferred to London could in times of depression *serve as a part* of the general reserves in the hands of the India Office for the support of exchange; and Government therefore followed a deliberate policy of increasing steadily the *gold* portion of the Paper Currency Reserve, which alone could serve this purpose in case of need. This was a *material change in the object* of the Paper Currency Reserve.

(3) Thirdly, from 1903 onwards Government pursued steadily the policy of universalizing notes of small denominations with a view to enhancing their popularity. By 1910, notes of small denominations up to, and including, those for Rs. 100 became *universal legal tender* throughout India, and encashable as of right at the head office of the *seven* circles. This had a very great effect on the *volume of circulation*, as can readily be seen from the following table (in crores of rupees) taken from the report of the Chamberlain Commission :—

Average of year	Gross circulation i.e. the value of all the notes issued and not yet paid off	Net circulation i.e. gross circu- lation less the value of notes held by Govern- ment in its treasuries	Active circulation i.e. the net circu- lation less the value of notes held by Presid- ency Banks and their head offices
1900-01	28·88	26·54	22·05
1906-07	45·14	41·48	33·93
1911-12	57·37	51·83	41·89
1912-13	65·62	54·92	45·39

6. Such was the state of affairs when the Chamberlain Commission made a searching examination of the whole system. The Commission in their final report made a number of valuable suggestions. They declared themselves in favour of the immediate universalization of the 500-rupee note, and of increasing the facilities for the encashment of notes. They advocated, further, a radical departure from the general principles of the English Bank Charter Act of 1844, on which the Indian Paper Currency System had so far been regulated. They recommended that the fiduciary portion of the note-issue should be increased from fourteen crores to twenty crores, and thereafter fixed at a maximum of the amount of notes held by Government in the Reserve Treasuries *plus one-third of the net circulation*, and suggested that Government should take power to make *temporary* investments or loans from the fiduciary portion within this maximum in India and in London, as an alternative to investment in permanent securities.

The Commission expected the following advantages from the policy they recommended: (1) While the permanent addition to the invested portion of the Reserve will be no more than is justified by past practice and experience, without in any way endangering the complete convertibility of the notes, the revenues of India will secure the profit earned by investing the amount now held idle in the form of gold in India. (2) There will be occasions, especially in the busy season, when it will be safe to lend temporarily sums which it would be unwise to invest permanently. The power to make such loans will, therefore, enable the Government to earn interest on sums which would otherwise be idle needlessly, and will provide at the same time a much-needed facility for a temporary expansion of the currency in the busy season, by virtue of which the market may obtain some relief, though not at first, perhaps, a very great amount, from its recurrent stringency. (3) The power to make temporary investments in London on account of the Paper Currency Reserve, will be a convenience to the Secretary of State in permitting him to sell Council Drafts against the Paper Currency Reserve, in anticipation of silver purchases or of any other cause, without the loss of interest and other disadvantages which might sometimes come about if he were compelled, without discretionary power, to utilize the entire proceeds of such sales in ear-marking.

gold. (4) As the circulation of notes in India increases, it will be within the power of the authorities to increase, as and when desirable, either the permanent or the temporary investments of the Reserve or both without a special Act. (5) The power to make loans from the cash held against notes in the Reserve Treasuries will provide the Government with a useful alternative or supplementary means of counteracting some of the disadvantages arising from the existing Reserve Treasury system.'

7. This report, however, was still-born. Its recommendations were yet under the consideration of the Government of India when war broke out. It was therefore decided to postpone further action on the report until the return of normal conditions. Meanwhile, war subjected the Indian Paper Currency System to a severe strain and important developments took place in the Indian Paper Currency System.

(1) The *legal limit of the invested portion* of the Paper Currency Reserve, which prior to the war stood at fourteen crores, was between 1915 and 1919 raised nine times, till at the end of 1919 it stood at 120 crores, of which 20 crores could be invested in securities of the Government of India. This made it possible to issue large quantities of paper money *without any metallic backing* behind them. 'During this period the gross circulation of notes increased nearly three-fold while the percentage of the metallic backing decreased by nearly one half.' This is shown by the following table :—

(in lakhs of rupees)

Date		Gross note circulation	Percentage of the metallic Reserve to gross note circulation
March 31, 1914	...	66,12	78·9
Do. 1915	...	61,63	77·3
Do. 1916	...	67,73	70·5
Do. 1917	...	86,38	43·9
Do. 1918	...	99,79	38·4
Do. 1919	...	153,46	35·4

(2) The use of paper currency was further encouraged by the issue in December, 1917 and January, 1918, of notes of Rs. 2-8 and Re. 1 respectively. In 1918-19, owing to the high price of silver, Government curtailed the supply of rupees, and forced the public to fall back upon paper currency even for small transactions. The result was that in the year 1918-19, the circulation of one-rupee notes increased from Rs. 33 lakhs to Rs. 1,051 lakhs, and that of 2½-rupee notes from Rs. 18 lakhs to Rs. 1,66 lakhs.

(3) The force of circumstances obliged Government to drift on to a policy of making our notes *de-facto* inconvertible. Owing to a steady fall in the percentage of metallic backing, Government withdrew in 1916 the pre-war facilities for encashing notes at the District Treasuries. But in spite of this restriction, the situation grew rapidly worse. In April, 1918, the silver balances of Government fell to under 10½ crores, that is about 8 crores less than what was regarded as a safe minimum before the war. The unfavourable war news in March and April, 1918, produced a run on the Bombay Currency Office, and it seemed almost certain that Government would be forced to declare the notes to be legally inconvertible. But this contingency was avoided by the timely announcement of the purchase of a large amount of silver from the Government of the United States. The impending crisis, however, showed the wisdom of conserving, as far as possible, India's metallic resources, if future trouble was to be avoided. With this object in view Government *prohibited the booking of specie by rail and steamer* and 'limited the daily issue of rupees to single tenderers of notes to a figure which made it practicable to satisfy large demands in part and small demands as a rule in full.' These restrictions resulted at first in a considerable *discount* on notes in many parts of India, especially on the new 2½-rupee and one-rupee notes; but 'the discount rapidly diminished when it was seen that the notes were freely accepted in payment of Government dues, and when small coin was made available in large quantities.'

(4) A new feature was introduced in the Paper Currency Reserve in the year 1916-17. Owing to the rise in the rate of interest, the market value of the old 2½ per cent British securities had declined enormously, and with a view to replacing them gradually by more suitable securities it was decided to create a

Paper Currency Reserve Depreciation Fund out of the interest received on paper currency investments.

8. These changes along with other effects of war on the Indian exchange and currency system were the subject matter of consideration by the Babington Smith Committee appointed on May 30, 1919. The Committee submitted its report on December 22, 1919, and made the following recommendations in connection with the Paper Currency Reserve :—

(1) The statutory minimum for the metallic portion of the Paper Currency Reserve should be *40 per cent.* of the gross circulation. As regards the *fiduciary* portion of the Reserve, the holding of securities issued by the Government of India should be limited to twenty crores. The balance should be held in securities of other Governments comprised within the British Empire, and of the amount so held not more than ten crores should have more than one year's maturity, and all should be redeemable at a fixed date. The balance of the invested portion above these thirty crores should be held in short-dated securities with not more than one year's maturity, issued by Governments within the British Empire. The existing permissive maximum of 120 crores should be retained for a limited period. The sterling investments and the gold in the Paper Currency Reserve should be re-valued at two shillings to the rupee.'

(2) With a view to meeting the seasonal demand for additional currency, provision should be made for the issue of notes up to five crores *over and above* the normal fiduciary issue as loans to the *Presidency* Banks on the security of *export* bills of exchange.'

(3) The silver and gold in the Paper Currency Reserve should be *held in India* except for *transitory purposes*.'

(4) As soon as circumstances permit, free facilities for the *encashment* of notes should be given, and the restrictions imposed during the war should be withdrawn. The Government should have the option of redeeming its notes in full legal tender gold or silver coin.'

It is easy to see that recommendations (1) and (2) imply a radical change in the principles of the pre-war Indian Paper Currency System. If the pre-war system was too inelastic

¹ Babington Smith Committee's *Report*.

and rigid, the *pendulum seems to have swung in the opposite direction*, and elasticity has been sought to such an extent *as almost to jeopardize the safety of the system*. The recommendations of this Committee in-favour of elasticity go much further than those of the Chamberlain Commission. The report admits that under the recommendations of the Chamberlain Commission it would have been necessary to provide at the time of the report a metallic reserve to the amount of 119 crores as compared with only 80 crores or so held at that time. But it was contended that so large a reserve was not required for ensuring the convertibility of the note-issue (*vide para. 78*). It should not be forgotten that the currency notes in India were *legally convertible into rupees only*, and that the latter contained silver worth much less than their official or legal value. So that if we were to convert coins into bullion, a 40 per cent metallic reserve in coin was hardly equal in normal times to a 30 per cent metallic reserve in terms of silver bullion. Add to this the further recommendations that when permanent legislation was introduced in replacement of the temporary provisions then existing, authority for retaining for a limited period the *existing permissive maximum of 120 crores for the fiduciary issue* should be sought (though in the pre-war period the invested portion of the Paper Currency Reserve was limited only to fourteen crores), and that in addition to this amount Government was to be authorized to issue notes up to five crores on the security of commercial bills of exchange *without any metallic backing whatever*, and one can easily realize what a long way the Indian Paper Currency System was being moved from that ideal safety aimed at by the principles of the Bank Charter Act on which the pre-war Indian paper currency had been regulated. It was admitted by official experts like Mr. Howard that 'we have unfortunately been compelled by the force of circumstances during the war to go very considerably further than the Chamberlain Commission recommended, or *than prudence would have dictated* if events had not been too strong for us.' It was *recognized in theory* by the Committee that there was a 'special need for caution in dealing with the note-issue in such a country as India, where a large part of the population is illiterate and the extended use of paper currency is a habit of very recent growth'; but these recommendations, which were in reality so much at variance with this,

excellent maxim, were made under the specious plea that it was essential to introduce elasticity into the system. Nobody denied the need of some elasticity ; the point at issue was the extent to which elasticity was to be pursued consistently with *safety*. No case was made out for going much further than the Chamberlain Commission recommended ; and no heed was paid to the contention of the *only Indian member* that even ' 80 per cent would not be too high a figure to fix as a normal proportion of *metallic reserve* to the total of notes outstanding.' (*Vide* para. 27 of Mr. Dalal's dissenting minute.)

It is necessary in this connection to bear in mind the *peculiar conditions* of India so forcibly pointed out by Sir Vithaldas Thakersey in the following extract from his evidence before the Babington Smith Committee :—

Q. 5787. If you have a note-issue of 200 crores, you would hold 150 crores in metal?—Yes, at least.

Q. 5788. Is that not a very large proportion compared with the amount found necessary in most countries which have a paper currency?—Yes. I have been now all over the world ; I have been in China, Japan, and America, and I have been watching the movement of silver. In India metallic currency is largely used, and therefore it is necessary to hold a larger reserve. In Japan, I did not ordinarily see a metal coin ; even the ten and twenty cents are in paper. The reason is that the people have been educated. They can all read. On the other hand, people in India are poor ; they are uneducated. They know the value of the metal but they do not know the value of paper. Then during the monsoon, paper is worthless to them. They carry their money in their *dhotis* and they get wet ; currency notes get dilapidated, torn, or lost, and they burn in a fire. All these difficulties are peculiar to India.

It must be admitted, however, in fairness to the Babington Smith Committee that its recommendations sought to *effect an improvement* in the conditions existing in 1917 and 1918 or those permissible under the law. During the period of war, Government had expanded the fiduciary note-issue to an enormous extent. As Mr. Dalal put it, ' It was no longer a case of investing a portion of the metallic reserve held in India against outstanding notes ; notes were boldly issued against which no metallic reserves in India had ever existed. Also the proportion of the metallic reserves to the

total of outstanding notes was not allowed to have any weight. It was a case of *simply watering the note-issue in its worst form*—issuing notes without any metallic backing. In other words, it was a forced loan from the Indian public, free of interest.' The recommendations of the Committee were certainly an improvement on the state of affairs in 1918 and 1919. (*Vide* table on page 22.) The operation of these recommendations is illustrated by the Committee by means of the following figures, exhibiting the composition of the reserve (a) as it stood on November 30, 1919, (b) as it would stand if the invested portion was at the maximum permitted under the then existing law, and consequently if the metallic reserve was at the minimum possible, and (c) as it would stand if the invested metallic reserve did not exceed the minimum permitted under their recommendations :—

—	Gross note circulation	Silver	Gold	Securities		Percentages of total Metallic Reserve to gross Note Circulation
				Indian	British	
Actual figures for November 30, 1919 ...	179,67 lakhs	47,44	32,70	17,03	82,50	44.6
Figures showing the maximum fiduciary issue under the then existing law ...	179,67 ..	59,00	67	20,00	100,00	33.2
Figures showing the maximum fiduciary issue under the Committee's proposals ...	179,67 ..	71,00	87	20,00	87,80	40

A word may here be said in justification of the limits imposed by the Committee on the various forms of investments in the Paper Currency Reserve. The experience of war had shown the worthlessness of all long-dated securities in times of stress; even British Consols, which in pre-war days were regarded as readily saleable securities in all circumstances, were found to be practically unrealizable in times of grave crisis. The rupee securities in particular were likely to be unmarketable at the very

time when it would be necessary to turn them into cash. There would be a run on the currency offices only when there was loss of confidence in Government. At such times the rupee securities too would be valueless. It was unwise on the part of a Government that expected to raise frequent loans in the market to rely, in a crisis, on its ability to turn into cash the additional securities created for issue to its Paper Currency Reserve. The second recommendation of the Committee was intended to provide adequately for the *seasonal* fluctuations in the demand for currency, and was suggested by the Federal Reserve Board system in America. The only way in which, under the pre-war system, currency could expand in India in the busy season, was by the issue of rupees or notes in India against either the tender of gold in India or sterling in London. Both these courses meant an import of funds from abroad. Internally there was no device for expanding the currency to satisfy the demands of trade in the busy season. The result was that discount rates soared high during this period of financial stringency. With a view to curing this defect, several witnesses before the Committee suggested a more elastic provision for the *discounting of Commercial bills*. The arguments in favour of this course were summed up by Mr. Howard as follows: 'Very briefly, circulation due to discounts of this kind is automatically regulated by the demand for currency and entirely eliminates any danger of permanent inflation. The security is absolutely good, and the arrangement is based on the fact that (as *The Times* put the position) "a self-liquidating bill has a self-retiring note as its concomitant." This would be particularly the case in India where the seasonal fluctuations occurring within very brief periods are so violent; and the existence of this facility might of itself tend to do a great deal to level down the bank rate, even though it was not at first taken very extensive advantage of.'

9. These recommendations of the Committee were in the main accepted by Government and incorporated in the Paper Currency Act of 1920 and the Consolidating Act of 1923. The only change of importance was in the minimum percentage of the metallic portion of the reserve, which was fixed at 50 per cent instead of 40 per cent of the gross circulation.

The permanent composition of the Reserve is now governed by Section 18 of Act VI of 1923, which runs as follows :—

(1) The provisions contained in this Section shall not come into operation until such day (hereinafter referred to as the appointed day) as the Governor-General in Council may direct in this behalf.

(2) A reserve shall be maintained for the satisfaction and discharge of the currency notes in circulation, and all such notes shall be deemed to have been issued on the credit of the revenues of India as well as on that of the Reserve.

(3) The reserve shall consist of two parts, namely :—

(a) The metallic Reserve ; and

(b) the securities Reserve.

(4) The metallic Reserve shall consist of the total amount represented by the sovereigns, half-sovereigns, rupees, silver half-rupees, and gold and silver bullion for the time being held on that account by the Secretary of State for India in Council and by the Governor-General in Council :

Provided that no amount of gold coin and bullion held by the Secretary of State in the United Kingdom in excess of fifty millions of rupees in value reckoned at the rate hereinafter provided for shall be included in the metallic Reserve.

(5) The securities Reserve shall consist of the securities which are for the time being held on that account by the Secretary of State for India in Council and on behalf of the Governor-General in Council :

Provided that—

(a) No securities held by the Secretary of State for India in Council, other than securities of the United Kingdom, the date of maturity of which is not more than one year from the date of their purchase, shall be included in the securities Reserve ; and

(b) the securities held on behalf of the Governor-General in Council shall be securities of the Government of India, and shall not exceed in amount two hundred millions of rupees, of which an amount of not more than one hundred and twenty millions of rupees may be securities created by the Government of India and issued to the Controller (such securities being hereinafter referred to as created securities).

(6) For the purpose of this Section the expression 'currency notes in circulation' means the whole amount of currency notes at any time in circulation :

Provided that currency notes which have not been presented for payment, in the case of notes of the denominational value of fifty or one hundred rupees, within forty years, and in the case of notes of any denominational value exceeding one hundred rupees, within one hundred years, from the first day of April following the date of their issue, shall be deemed to be not in circulation :

Provided, further, that all such notes shall be deemed to have been issued on the credit of the revenues of India and shall, if presented for payment, be paid from such revenues.

(7) Save as hereinafter provided in Section 20, the amount of currency notes in circulation at any time shall not exceed the amount of the metallic Reserve together with the amount of the securities Reserve :

Provided that it shall not be lawful for the Governor-General in Council to direct the issue of currency notes, if or to the extent that such issue would have the effect of raising the amount of notes in circulation to an amount in excess of twice the amount for the time being of the metallic Reserve.

For the purpose of determining—

(a) the amount of the metallic Reserve, gold bullion shall be reckoned at the rate of one rupee for 11·30016 grains troy of fine gold, and silver bullion at the price in rupees at which it was purchased.

(b) the amounts of the securities Reserve, purchased securities shall be reckoned at the price at which they were purchased, and created securities at the market price of similar securities on the date of their issue.

(9) The securities of the Government of India in the Reserve shall be held by the Controller and the Master of the Mint at Calcutta or of such other Mint as the Governor-General in Council may direct in this behalf, in trust for the Secretary of State for India in Council.

10. The following table shows the gross circulation of our currency notes and the composition of our Paper Currency Reserve since 1920:—

	Total notes in circulation	COIN AND BULLION					Securities	
		In India					Held in India	Held in England
		Silver coin	Gold coin and bullion	Silver bullion under coinage	In England Gold coin and bullion	In transit Gold coin and bullion		
March 31, 1920 ...	1,74,52,45,960	33,21,91,696	44,36,53,445	6,63,25,959	Nil.	3,44,71,947	19,58,54,946	67,27,17,967
Do. 1921 ...	1,66,15,69,950	61,42,09,884	24,17,13,026 (c)	4,14,47,032	Nil.	Nil.	68,07,15,946 (a)	8,34,83,862
Do. 1922 ...	1,74,76,47,252	72,96,22,264	24,31,91,937 (c)	4,55,67,211	...	...	65,07,93,571 (b)	5,84,72,269
Do. 1923 ...	1,74,70,14,780	82,49,73,905	24,31,88,263 (c)	4,55,67,311	...	...	57,48,07,571 (b ¹)	5,84,77,739
Do. 1924 ...	1,85,85,07,224	74,18,27,369	22,31,93,347 (c)	5,82,16,762	...	...	57,52,74,946 (b ²)	1,39,90,480 (c)
							plus	
							12,60,00,000	(d)

(a) Includes Rs. 61,26,00,000 Indian Treasury Bills.

(b) Do. Rs. 57,89,00,000 Indian Treasury Bills.

(b¹) Do. Rs. 49,65,00,000 Indian Treasury Bills.

(b²) Do. do. do. do.

(c) At Rs. 10 per £1 or Re 1 for 11-30016 grains fine gold.

(d) Internal bills of exchange under Sec. 20 of Act X of 1925 as amended by Act XXXVI of 1923.

11. Let us now recapitulate briefly the salient features of the Indian Paper Currency System as it exists at present :—

(1) The function of note-issue is still dissociated from banking in India and is still retained by Government. But the Indian Paper Currency System is far more elastic than it was in pre-war days.

(2) Government is under a legal obligation to issue currency notes of various denominational values in exchange for an equivalent amount in rupees, or silver half-rupees, or in gold coin which is legal tender under the Indian Coinage Act 1906, or for gold bullion at the rate of one rupee for 11·30016 grains troy of fine gold.

(3) Notes of the denominational value of one rupee, ten rupees, fifty rupees, one hundred rupees, or of any other denominational value which the Governor-General may by notification in the *Gazette of India* declare as 'universal currency notes' are legal tender at any place in British India. Any other note is legal tender only within the circle from which the note was issued.

(4) Indian currency notes are legally convertible into rupees only.

(5) The Indian Paper Currency Reserve includes (i) Securities Reserve consisting of (a) Securities of the Government of India not exceeding in amount twenty crores, (b) Securities of the United Kingdom, the date of maturity of which is not more than one year from date of purchase, (c) Bills of exchange which will mature within ninety days, not exceeding in amount twelve crores; and (ii) a Metallic reserve, not less in value than parts (a) and (b) of the Securities Reserve.

CHAPTER IV

FOREIGN EXCHANGES

1. The changes in 1893 were inspired, as we have already shown, by a belief in the possibility of raising artificially the gold value of the rupee by limiting the quantity of rupees in circulation. But the reason why Government sought to give the rupee some artificial value was the serious inconvenience the free and automatic silver standard was supposed to have caused to various classes of people including Government. The frequent variations in the gold value of silver were accompanied by wide and frequent fluctuations in the external value of the rupee, introducing an element of uncertainty in the commercial and financial transactions between England and India. For instance, the exporter from India was paid by a bill of exchange on London payable in sterling by the British consignee, but he himself purchased the produce in the Indian market with *rupees*. Similarly the importer in India paid for his goods in London in sterling but received his selling price in India in terms of rupees. Each had to change sterling into rupees, or rupees into sterling; and each found his calculations upset by the fluctuations in the relative values of the two. How wide and frequent the fluctuations were, may be seen by a glance at the following table :—

					RATE OF EXCHANGE
					<i>s.</i> <i>d.</i>
Average of five years	1860-61 to	1864-65	...	...	1-11·892
Do.	do.	1865-66 to	1869-70	...	1-11·310
Do.	do.	1870-71 to	1874-75	...	1-10·576
Do.	do.	1875-76 to	1879-80	...	1-8·534
Do.	do.	1880-81 to	1884-85	...	1-7·644
Do.	of the year	1885-86	...	...	1-6·254
Do.	do.	1886-87	...	...	1-5·441
Do.	do.	1887-88	...	...	1-5
Do.	do.	1888-89	...	...	1-4½
Do.	do.	1889-90	...	...	1-4½
Do.	do.	1890-91	...	...	1-6½
Do.	do.	1891-92	...	...	1-4½
Do.	do.	1892-93	...	...	1-3

It was to stop this element of chance and uncertainty that the Government of India embarked upon the monetary revolution of 1893. They aimed at controlling the sterling value of the rupee (or the 'rupee-sterling exchange' as it is technically called), at fixing it to some constant level so as to reduce these fluctuations to a minimum.

2. What are the natural causes of these variations in exchange which the Government of India sought to control? Why is it that the external value of the currency of one country in terms of that of another country varies at all? The answer to this question lies in what is technically known as the 'Theory of Foreign Exchanges.' But in order to be in a position to grasp this theory it is necessary to bear in mind a few details about *bills of exchange*—the instruments most commonly employed in the settlement of obligations between different places.

Suppose merchant A at Karachi buys wheat from merchant B at Lahore, and merchant C at Lahore buys cotton cloth from D at Karachi. To simplify matters, let the amount involved in both the cases be the same, say Rs. 1,000, and let it be payable in each case three months hence. On account of these transactions, the merchant B at Lahore acquires the right to call upon A at Karachi to pay Rs. 1,000 three months hence; and similarly D at Karachi acquires the right to order C at Lahore to pay the same amount by the same time. It is easy to see that if D sells to A his claim on C, and A makes it over to B, both B and D can realize their claims without any money passing from Karachi to Lahore and vice versa. These orders, or bills of exchange as they are called, are thus a means of transferring debts from one person to another; and merchants anxious to secure the most convenient means of remittance to different places are generally on the look-out for them, with the result that every commercial centre develops a market for bills on other centres. To make a bill of exchange *readily saleable* in the market, it is necessary, however, that it should carry on it some evidence that the party on whom it professes to be drawn would acknowledge his liability to pay it at the due date. In technical language, the drawee or some one on his behalf must sign his 'acceptance' on the bill of exchange to make it 'negotiable'.

A bill of exchange payable *after a time* is obviously not so convenient as *cash* to those who are in need of ready money.

Banks and discount houses at this stage come to the help of trade. If a bill of exchange is 'accepted' by a party of some standing, banks would readily 'discount' it or turn it into cash, after deducting a small amount for advancing money before it *matures* and for the risk they run in buying commercial paper. In other words banks lend money for the interval between the date of discounting and the date of maturity. Further, to accommodate trade, banks and accepting houses often 'accept' bills on behalf of their customers so as to facilitate their discounting in the market. A bill of exchange has therefore to pass through two stages before it is converted into cash—it has to be 'accepted' and 'discounted'.

All these details are described in semi-technical language by Prof. Marshall as follows: 'A bill of exchange is generally a written request by the "drawer" of it, addressed to another, the "drawee", in which he is requested to pay a certain sum of money to a person indicated on the face of the bill and called the "payee". This person may be the drawer himself or a third person. It may request the drawer to pay it to any one to whom the payee may transfer the bill, subject to certain conditions and formalities. The bill states the time at which it is payable, as for instance, at sight, or at three months from date. When the bill has been "accepted" by the signature of the drawee written across its face, it then becomes a promissory note from him, its acceptor. For a payee may sell it to a second person, who may sell it to a third, and so on; each seller signing it on the back, or endorsing it, before he passes it on. The selling value of the bill is reached by deducting a "discount" from the value on the face of it. This discount varies, firstly with the time for which the bill has yet to run; secondly with the market rate of discount on short, secure loans; and thirdly, with the risk that it may be difficult, or even impossible, to collect the value of the bill. The demand for payment of it will be made in the first instance on the acceptor of the bill; and failing him, from the drawer; and failing him, from its endorsers in the order in which they have signed their names.'

3. We are now in a position to deal with 'Foreign Exchanges' or commerce in bills of exchange on foreign countries. Let us take the easiest and the simplest case first—that of exchange between two centres A and B, which have the same

gold coin (or paper currency freely convertible into gold) as their legal tender, and which impose no impediment on the free movements of gold—the case represented, for instance, by Sydney and London in pre-war days. At any one time there will be found a number of persons in A who have to make payments to their creditors in B, and a number of others who have to receive money from their debtors in B. One of the ways of remitting money from A to B is to buy in A a bill of exchange on some one in B from those who are willing to sell such a bill in A. If on the whole A has for any reason to send more money to B than B has to remit to A, the demands for bills on B (say of 100 units payable at sight) will be greater than their supply. The value of each will rise above 100 and exchange would then be said to be *favourable* to B. But no one would ordinarily give for such a bill more than what it would cost to get its gold equivalent and ship it to his creditor; for when there are two ways of remittance open to any one, he will, for obvious reasons, choose the one which costs less. The price of a bill on a first-rate party in B, payable at sight, cannot therefore in ordinary circumstances amount above its face value in bullion by more than the cost of sending bullion. This limit is technically known as the *upper specie point*. If on the other hand A has, for any reason whatsoever, to receive more money from B than B has to send to it, the supply of bills of exchange on B (say of the face value of 100, payable at sight), will be greater than the demand. The value of each will be lower than 100 and exchange would then be said to be unfavourable to B. But it would not ordinarily go below 100 *minus* the cost of shipping gold coins (or bullion worth as much) from B to A, because in that case it would be cheaper for those who have to get money from B to realize their claims in gold and have it shipped from B to A, rather than sell their bills of exchange on their debtors in B. This limit is known as the *lower specie point*. The market value of such a bill of exchange on B would thus, *in normal circumstances*, fluctuate between the *upper and the lower specie points* in accordance with the keenness of demand in A for bills on B.

Circumstances, however, are not always normal. There are times when exchanges sink and rise beyond specie points even in the case under consideration. For instance, the exporters in

a country, at times, labour under the urgent necessity of selling their bills *immediately* at any sacrifice and cannot afford to wait for the arrival of specie.¹ A commercial panic or a stringent money market may create a reluctance on the part of purchasers to buy bills, unless absolutely compelled to remit. Again, a whole nation may at a particular moment fall into discredit, and it may become difficult to sell bills on it. Such peculiar contingencies, however, do not occur often; and may therefore be ignored as exceptions to the general rule.

We have so far assumed that bills on a particular centre are all payable immediately and are all drawn on first-rate parties. But this is not always the case in real life. Bills vary both as to the security behind them and as to the time when they are due for payment. A promise made by a man of straw is obviously not so reliable as one by a respectable person; and therefore the value attached to a bill of exchange would vary with the standing of the acceptors, other things being equal. For obvious reasons, again, no one would give for a promise three months hence, as much as for a *cable* or *telegraphic* transfer, payable as soon as the telegram reaches the other centre, or for a '*sight bill*', which is payable on presentation to the drawee, or a '*short sight bill*', payable after a limited period after sight. Apart from the general *state of indebtedness*, then, the price of bills of exchange would depend on their *intrinsic merits* as promises, and the *time* when they are due for payment.

This brings us to another factor—the rate of interest or discount. The cash value of a bill of exchange, payable ninety days hence, will depend on the rate of discount ruling in the centre where the bill is payable. If a man owes money abroad, he will be paying interest to his foreign creditor so long as his debt remains unpaid. Accordingly it will make a difference to him of ninety days' interest at the foreign rate, whether the bill he purchases as a remittance is payable at once or ninety days after sight. He will be inclined to make a heavier deduction from the face value of a ninety days' bill when the foreign rate of interest is high than when it is low.

Even in the case of bills of exchange payable *at sight*, the rate of interest is an important element in their price, when the

¹ See Goschen's *Foreign Exchanges*.

centre on which they are drawn is *a distant one*. For instance, even when exchange between London and Sydney was at par in pre-war days, it paid the Australian banker to give more for a sovereign in London, because he received the sovereign in London at once, while his balance in Sydney was drawn upon five weeks later, when the draft arrived there by mail. He had thus the use of the purchaser's money for five weeks; and in times when the rate of interest was high, this was by no means an unimportant consideration.¹

In the case under discussion then, three main factors influence the price of 'sight bills' drawn on first-rate parties in a foreign centre, namely: (1) the state of mutual indebtedness *to be met within a defined period of time*; (2) the cost of shipping specie; and (3) the rate of interest.

4. Let us now take another case—that of places having a gold standard but using a different *coin*; say for instance, Paris and London in pre-war days. The French monetary unit was the franc, while the English unit was the sovereign, and therefore a bill on Paris was payable in francs, while one on London was realizable in sovereigns. The gold contents of the two coins, however, were not the same. The quantity of gold necessary for minting a sovereign in England would, if taken to the French mints, have sufficed for coining twenty-five francs and twenty-two centimes; and therefore the equation £1 = 25f. 22c. was known as the *mint par* of exchange. The cost of shipping a sovereign worth of gold from London to Paris or Paris to London in pre-war days was about 7 c.; and so the pre-war specie or gold points were 25 f. 15 c. and 25 f. 29 c.

The fluctuations of London-Paris exchange within these limits were governed by the same influences which we have considered in the first case, and need therefore no further discussion.

The reader should not conclude from the reasoning followed in these two cases, that the rate of exchange between gold standard countries could never rise above or fall below the specie points. The facts of real life are not so simple as that. The theory was borne out by facts only where there was a *free market in gold* and a claim for money carried with it an unquestionable right to immediate payment in gold. These conditions existed only

¹ See Hartley Withers' *Money-changing*.

in pre-war England. Elsewhere 'the theoretical gold point was only the point at which it paid better to send gold than buy a bill, *if you could get the gold*.'¹ Export of gold was *not free* in other centres; and therefore exchange on London in other centres sometimes rose above the theoretical specie point without any specie coming to London. For example, the *mint par* of exchange between Berlin and London was in pre-war times 20 marks 43 pfennings, and the expense of sending gold from Berlin to London only 5 pfennings, and yet in November, 1912, the Berlin exchange stood for some weeks at or above 20 marks 53 pfennings without any gold being shipped to London. The same results ensue when the movement of specie (gold and silver) is not only restricted but *stopped altogether*, as was actually the case in time of war. The theoretical 'gold points' are then inoperative, because the alternative of remitting specie is not open to the public, and exchange fluctuations are not limited by them.

In pre-war times, when there were no restrictions on the movements of gold, the export of gold from one standard country to another kept within narrow limits the fluctuations in the prices of bills of exchange. It reduced the outstanding balance of the centre which had an unfavourable exchange, and altered the relative price-levels in the two centres in such a way as to provide natural correctives to adverse exchange. For instance, the export of gold from A to B tended to produce a *fall* of prices in A and a *rise* in B; the resulting higher price-level in B acted as a stimulus to exportation from A to B, and so turned the balance of accounts again in favour of A. Bills drawn in A on B then tended to multiply, and specie point being reached, gold went back from B to A till prices in A were again as high as in B. So long, therefore, as national currencies were effectively based on gold, and no impediment was placed on export, the gold prices of exportable commodities tended to equality everywhere, allowance being made for costs of carriage, frontier taxes, etc., etc., and 'adverse balances' of any magnitude created automatically forces which tended to reduce them.

5. Let us now take a third case into consideration—that of exchange between gold standard countries on the one hand, and those with currencies based either on a free and automatic

¹ See Hartley Withers' *Money-changing*.

silver standard or on inconvertible paper on the other. Here there is no such thing as a *mint par* of exchange, nor are there any gold points within which exchange fluctuates. The factors governing exchange in the first two cases, namely, the balance of relative indebtedness, the rate of interest in the two centres, and the state of credit, are all operative in this case also; but their influence is considerably modified by variations in the gold price of silver or in the quantity of paper currency which changes the purchasing power of the standard in terms of gold, the only international money. At the present time, for instance, the exchange between New York and Berlin is subject to violent fluctuations, mainly because the purchasing power of the German mark has been declining fast owing to the over-issue of the German paper currency, which is no longer convertible into gold.

6. There remains still the last, and at the present time the most common, case of exchange between countries, each of which has an independent system of inconvertible paper. Here the balance of trade theory does not seem to afford any adequate explanation of the wide fluctuations in foreign exchanges. The theory most popular at present among writers on this subject is the doctrine with which Professor Cassel has familiarized the public under the name of 'Purchasing power parity' and explained by him as follows :—

'Our willingness to pay a certain price for a foreign money must ultimately and essentially depend on the fact that this money has a purchasing power as against commodities and services in the foreign country. On the other hand, when we offer so and so much of our own money, we offer, in fact, a purchasing power against commodities and services in our own country. Our valuation of a foreign money will, therefore, essentially depend on the relative purchasing power of the currencies of both countries.

'Given a normal *freedom of trade* between two countries, A and B, a rate of exchange will establish itself between them, and this rate will, smaller fluctuations apart, remain unaltered as long as no alteration in the purchasing power of either currency is made and no *special hindrances* are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished,

the value of the A-money in B must necessarily be reduced in the same proportion. And if the B-money is inflated and its purchasing power is lowered, the valuation of the A-money in B will clearly increase in the same proportion. If, for example, the inflation in A has been in the proportion of 320 to 100, and the inflation in B has been in the proportion of 240 to 100, the new rate of exchange will be three-fourths of the old rate. Hence the following rule: When two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from this new normal rate, and in a period of transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the *new parity* between the currencies. This parity may be called the purchasing power parity, as it is determined by the quotient of the purchasing powers of the different currencies.¹

On analysis, this doctrine will be found to be only a corollary from the following three propositions:—

- (1) A currency's *internal* purchasing power varies with its inflation or deflation in accordance with the quantity theory of money, discussed in chapter ii;
- (2) Its *external* purchasing power in a foreign country depends on—
 - (a) the rate of exchange between it and the foreign currency, and
 - (b) the foreign currency's purchasing power in its own country;
- (3) In *equilibrium*, its internal and external purchasing powers must be the same, for otherwise trade would be stimulated to take advantage of any inequality between the two. It follows, therefore, that the rate of exchange between any two currencies will, in equilibrium, tend to be the ratio between their purchasing powers.

The theory expounded above does not ignore the existence of *disturbing factors*. It does not overlook the fact that, owing to costs of transport, tariffs, and other causes, internal and external,

¹ Cassel.

the purchasing power of currencies can never be exactly equal. But its exponents attempt to overcome this difficulty by taking some base period, generally the year 1913, and assuming that the percentage difference between the internal and external purchasing power in that year may be taken as an approximately satisfactory correction for the same disturbing factors at the present time. It is further admitted that 'if trade between two countries is more hampered in one direction than in the other, the value of the money of the country whose export is relatively *more restricted* will fall in the other country, beneath the purchasing power parity.' Several other causes, such as distrust in the future of a monetary standard, operation of speculators, or the practice of selling out the currency of a country abroad, are all recognized to be capable of depressing the international value of the currency below its purchasing power parity. But these depressing factors are supposed to have only a temporary effect, for in the absence of any further restrictions on the exports of a country, '*every undervaluation of its currency will lead to an increase of its exports, tending to counteract this undervaluation*'!

Even in this modified form, the theory needs two important corrections. The equilibrium between the internal and external purchasing power of a currency is a necessary one only in respect of goods *entering into international trade*, and not in respect of *all* goods, bought and sold. The right basis for the valuation of the purchasing power parity is therefore an index number, not of *all* prices but only of *export* prices. It is wrong to assume, as is commonly done, that the general level of prices in a country *necessarily rises or falls* in the same proportions as the index number of the prices of her *exports*. Even in normal times, there is no exact correspondence between these two 'if the industries which produce these exports are not representative of the general body of her work in regard to method, energy, and ability; or if the movement of labour, manual and mental, between various localities and groups of industries within the country is not easy and rapid; or if many kinds of her agricultural and other bulky produce are raised at so great a distance from her frontier, that their prices at the frontier exceed very much the average prices

at which they are supplied to her own people.'¹ Much more so is it the case in the abnormal conditions of the world since 1914, when restrictions of all sorts have created at times two price-levels in many countries, one for foreign trade and another for internal trade, and when fluctuations in prices have been brought about not merely by monetary influences, but also by changes in other economic relations between countries. For example, the Reparations problem has altered, more or less permanently, the relative exchange values of Germany's imports and exports. Nor is the assumption, that the disturbing effect of tariffs, etc., is the same in degree to-day as it was in 1913, a valid one, for it is notorious that the 'tariff-costs'—using the term in an extended sense so as to cover all export and import regulations, including prohibitions and official or semi-official combines for differentiating between export and home prices—are widely different in many cases from those which existed in 1913. It is only when we restrict ourselves to articles entering into international trade and make exact allowance for transport and tariff-costs, that the theory will be borne out by facts, with perhaps a short time-lag.²

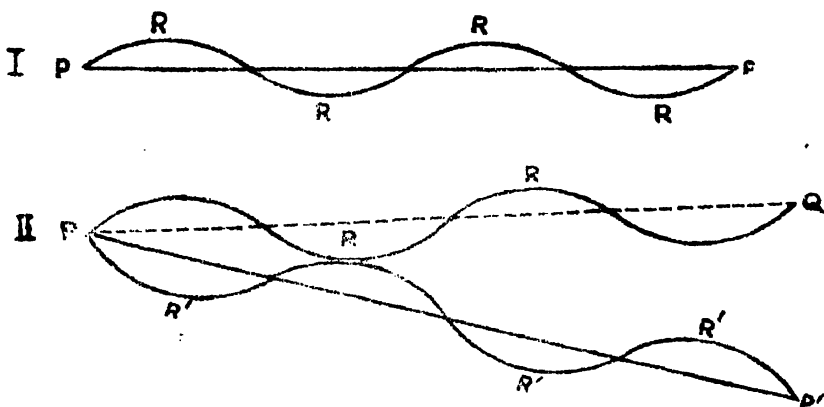
What about the influence of the 'balance of trade', which was regarded as the most important factor in the classical theory of foreign exchanges? There has been much discussion on the relative merits of the balance of trade and the purchasing power theories as explanations of the wayward course of foreign exchanges since 1914, and it may be said briefly in the words of Mr. Gregory that 'exchange experts at the present time are divided into two camps: those who think that exchanges are dislocated because of inflation, and those who think that they are dislocated because of an "excess of imports over exports."' Indications, however, are not wanting which show that some, at least, of those who are generally considered as representatives of the purchasing power parity school, do not mean to repudiate *in toto* the old balance of trade theory, though they reject it as an explanation of the changes in the *normal* rates of exchange as distinguished from temporary deviations of exchanges from the normal. According to them, the purchasing power parity has

¹ Marshall.

² See J. M. Keynes' articles in *Manchester Guardian* Reconstruction numbers.

taken the place of the old mint par of exchange between gold standard countries. It gives us to-day the normal rate of exchange, the point about which exchanges fluctuate but at which they must ultimately come to rest. It is, however, not a fixed ratio like the old mint par : it is a *moving* par, moving with the relative price-levels. Adverse trade balances can, and do, move exchanges away from this parity, but they are incapable of depressing *permanently* the exchange value of any currency. Their effect is only *temporary* ' for if a country buys more from another than it sells to it, the balance must be paid in some way, say by export of securities or by loans in the other country. Thus the balance of payments must on the whole equalize itself, and there is no reason for a *definite* alteration in the rates of exchange. ' With unaltered price-levels and unrestricted export of goods, an adverse exchange tends to correct itself, for in these circumstances the country's export trade receives a strong stimulus, which tends to bring the exchange back to its old normal rate. But if the relative price-levels are altered by excessive *inflation* in any country, ' a new normal equilibrium of the exchanges must establish itself, quite irrespective of any balance of trade. ' ¹ The change in that case is a *permanent* one : the *parity itself* has been lowered.

We may here illustrate the difference between the pre-war and post-war conditions of exchanges by means of the following diagrams, suggested by Miss E. C. Van Dorp in an article in the *Economic Journal*, 1919 :—



¹ Cassel.

Diagram I shows the fluctuations of exchange with a *fixed parity* in pre-war times, $P-P$ being the parity, and R the rate which fluctuates and tends towards the parity in accordance with fluctuations in the balance of trade. Diagram II illustrates the post-war conditions, $P-Q$ being the pre-war and $P-P'$ the post-war parity, and R' the rate. The fall of exchange in this case is not a fall below parity (i.e., a market rate below the normal rate) but a *fallen parity* (i.e., a fallen normal rate).

There is really nothing new in this doctrine. It only serves to focus attention on an underlying assumption in the old treatment of the subject—an assumption, the significance of which was not clearly realized by the more superficial among the older writers, that free movements of gold tend to bring price-levels at the ports in all gold standard countries nearly to a common level. In pre-war days, when most of the civilized countries were on a gold basis and imposed restrictions on the movements of gold, practical men were justified in ignoring the influence of price-levels at the ports on foreign exchanges, and confining themselves to those minor movements in the supply and demand for bills, which caused fluctuations in exchange within the limits of gold points, and which could be corrected by gold shipments, temporary borrowings, variations in the discount rate, and so on. But the root factor operating then as well as now is the constant pressure of exchange rates towards the purchasing power parities, arising from the fact that people continually seek to buy in the cheapest market and sell in the dearest. This seems to have been clearly realized by the more careful among the old writers on the theory of the subject. Prof. Marshall in particular dealt with it at length in his memorandum to the Gold and Silver Commission (1888) as the following extract from his evidence will show: 'It is impossible to discuss adequately in a memorandum the causes which determine the course of the foreign exchanges and the reciprocal influences which they exert on the course of the trade. I must, therefore, start by taking for granted the solution of these questions with regard to the trade between two countries, A and B, each of which has a gold currency.

'Ricardo's reasoning on this subject has been developed by Mill, Mr. Goschen, Mr. Giffen, Professor Bastable and others: and it is now clearly established that trade tends so to adjust

the supply of gold relatively to the demands of gold in the two countries as to *bring gold prices at the seaboard*s of the two countries to equality, *allowance being made* for carriage.

If they are higher in A than B, there will be a small temporary bounty on exportation from B to A, corresponding to this difference, which must always be small. Bills drawn in B on A will multiply, and, specie point being reached, gold will go from A to B till prices in B are as high as in A. If B hoards gold, this process may be a long one, otherwise it is sure to be short.

The fluctuations of the exchanges, measured in terms of gold bars, that is of gold regarded as a commodity, are limited in ordinary circumstances to the double cost of carriage of gold. But when measured *in terms of the currencies of the two countries*, the *limits of these fluctuations are liable to be extended* by the sum of the *seigniorages* (if any) charged in the two countries, and in extreme cases by the *sum of the amounts* lost by wear and tear, not indeed from the average coins in circulation, but from the picked coins which are selected for the purposes of export. . . . But, while referring to the ordinary textbooks for the general treatment of this part of the question, I wish to observe that its real nature has been in some measure disguised by the habit, borrowed from the city, of describing the trade in precious metals in different language from that used in describing the trade in any other commodity. If, on the balance, B is indebted to A, and in consequence the exchanges are favourable to A, merchants in B will consider what things they can send to A, and sell there at a price higher than they could get by investing the same money in a bill on A, on which they have to pay a premium; in every case they have to allow for cost of carriage, etc., and for interest on the time required for realizing. If the premium on the bill is just equal to the cost of carriage for gold, so that it is indifferent to a merchant whether he buys a bill or sends the gold, it is said that "gold point" has been reached. But with equal appropriateness, it might be said that "lead point" is reached, or that "Egyptian point" is reached, when the difference between the price of lead or of Egyptian bonds in the two countries is just balanced, after allowing for the charges of transport, by the premium at which a bill on A sells in B. The question whether any one thing such as lead can exercise any important influence in adjusting the balance of trade, depends

partly on its portability and partly on the extent of the market which it finds in either country. The power of gold for this purpose is therefore of primary importance between two countries which have a gold currency, for gold has in each a practically unlimited market. But its influence would be much weaker if one of the countries had a paper currency or a silver currency.

‘Firstly, let us consider the trade between England and Russia. Gold prices in England and rouble prices in Russia are determined by the work which the currency has to do in either country, on the one hand, and the volume of that currency on the other. And when trade is *in equilibrium, the gold price of the rouble will be fixed at the ratio which gold prices in England bear to rouble prices in Russia.* For suppose that it were not at this level, but were, say, below it; that is, suppose the number of roubles which were exchanged for one pound to be increased above the ratio which the goods priced at £1 in England bore to those which were priced at a rouble in Russia, allowance being made for transport, then exporters from Russia would sell their goods for gold, which, when converted into roubles, would give them more than ordinary profits; while importers into Russia would lose money if they sold their bills on Russia at the current rate of exchange. The immediate result would be, that these importers would refuse to sell at that price, but would prefer to buy Russian goods and bring them back. Exporters’ bills, in Russia would therefore be without any market at the *old* rate, and their value, or in other words, the rouble price of the sovereign, would fall almost instantaneously. That is, the *gold price of the rouble would rise* almost instantaneously until it was *equal to the ratio in which gold prices in England would stand to rouble prices in Russia.* In the same way it can be proved that the gold price of roubles cannot be in equilibrium above this level; and, therefore, that in equilibrium it must be at this level.’

This purchasing power parity theory is now coming to be recognized as the only intelligible explanation of the wayward course of foreign exchanges at present. It is difficult to account for the day-to-day movements in these ‘confounded exchanges’ by any other hypothesis. Incidents such as remittances abroad, minor movements in trade balances, or sudden developments in international politics cannot explain, for instance, the following

table compiled by the *Statist*, dated 28th October, 1922, of the fluctuations in the exchanges of Berlin, Paris, Brussels and Rome with London in the year 1922 :—

	Berlin (Marks to £1)	Paris (Francs to £1)	Brussels (Francs to £1)	Rome (Lire to £1)
1921, October 27 ...	680	54·06	55·12	99½
1922 (monthly averages till September) April.	1,227	47·90	51·90	82½
May ...	1,289	48·71	53·19	84½ ^a
June ...	1,389	51·54	54·04	89½
July ...	2,185	51·05	56·93	97
August ...	4,954	56·06	59·14	98½
September ...	6,454	57·82	61·27	103½
October 6 ...	9,525	58·15	62·15	103
Do. 13 ...	11,750	58·46	62·66	104½
Do. 20 ...	17,160	60·20	65·00	106½
Do. 27 ...	18,625	63·82	68·67	113½

That inflation overrides all other factors will be clear from a comparison of these with the established index numbers of wholesale commodities for the countries concerned. The compilations of the *Frankfurter Zeitung* for Germany show an advance in prices from 6,622 per cent above the pre-war level at the end of March (1922) to 28,819 per cent at the end of August (1922). The calculations of the *Statistique Generale de la France* show a rise for that country during the same period from 207·5 per cent above the pre-war level to 231·2 per cent ; while for Italy Professor Bachi's index number indicates an advance during these five months from 433·3 per cent above the 1913 level to 471·2 per cent.' ¹

7. We have now seen that one of the most important factors governing deviations from the par of exchange is the state of mutual indebtedness. How does this arise ?

(1) The foreign trade of a country is obviously an item in its credit and debit account with other countries. A country has to pay for the goods it imports from outside ; it is a debtor to the extent of its imports. It has to be paid for its exports ; it is a creditor to the extent of its exports. The exports of a country therefore increase the *supply* of bills of exchange on foreign

¹ *Statist*, October 28, 1922.

centres : its imports increase the *demand* for them. For instance, the exporter from India sells his goods abroad and is paid in a bill of exchange on a foreign centre, usually London, which is the clearing house of the world. He purchases his produce in terms of *rupees*, but he is paid for his goods in terms of *sterling*, which he would naturally like to convert into rupees. He is therefore a *seller* of a bill of exchange in sterling. On the other hand, the importer in India, for similar reasons, is a *buyer of sterling*. Supply and demand for these bills of exchange on London are thus governed by the condition of trade between India and outside ; and the rate of exchange depends on the relation between exports and imports.

Indian exports, being mainly raw agricultural produce, are affected materially by rains ; and consequently Indian exchange is dependent upon the character of the seasons. Normally, the busy season commences in September and is accompanied by steady exchange conditions. Exchange is most firm during the period October to May and is weakest in the slack season, June to September.

(2) Exports and imports are, however, not the only ground of international indebtedness. (A) International borrowing and lending is another item to be considered. If India borrows a large sum from England, the latter will be in the position of a *debtor* to us during the time the *principal* is being paid to us. This item will therefore figure on the credit side of India's account with England. A foreign loan thus tells against the balance, not of the borrowing country which receives the loan, but of the lending country which supplies it ; its effect is the same as that of additional exports from the country which borrows, or that of an increase in imports to the country which lends. In fact, the borrowing country *exports* its securities and the lending country *imports* foreign securities. This is the immediate effect of the loan ; its ultimate effects are different. The *interest* on the loan will be an item on the debit side of India's account with England ; so also will the *repayment* when India begins to repay the loan.

(B) Another supplementary cause of international indebtedness arises from the remittances by travellers, by those who reside abroad, and by philanthropists who contribute to the benevolent institutions of a foreign country. The earnings of Indian

merchants abroad, so far as they are transmitted to India, make India a creditor, while the earnings of foreign merchants, remitted to their native countries, make India a debtor for the time being. Similarly, the expenditure of foreigners in India will be an item on the credit side of India's account, while that of Indians going abroad for business, pleasure, or education will figure on the debit side.

(C) Remittances by Governments constitute another item in international indebtedness. For instance, the expenditure of the Indian Government in London makes India a debtor to this extent; and the payment of war indemnity by Germany to France will make Germany a debtor during the time the indemnity is being paid.

(D) Lastly, there are the payments due by one country to another owing to the commercial services rendered, e.g. commissions and brokerages, freight, pilot and harbour dues, marine insurance, and other charges of the same sort.

All these items affect the credit and debit side of a country's account just as much as the export and import of *goods*; hence those which figure on the credit side are often called 'invisible exports' and those that have to be placed on the debit side, 'invisible imports'.

The statement below compares India's visible balance of trade during each of the years 1919-23 with the average of the five years preceding the war and of the five years of the war.

(In lakhs of rupees)

	Average of 5 pre- war years ending 1913-14	Average of 5 war years ending 1918-19	1919-20	1920-21	1921-22	1922-23
Balance of trade in merchandise (private).	+ 78,27	+ 76,34	+ 1,25,99	- 77,55	- 20,90	+ 89,82
Balance of trans- actions in trea- sure (private).	- 36,07	- 10,80	- 10,82	+ 1,29	- 12,16	- 60,02
Balance of remit- tances of funds.	- 42,62	- 30,14	- 19,85	+ 27,76	+ 1,26	- 3,63
Total visible bal- ance of trade.	- 42	+ 35,40	+ 95,32	- 48,50	- 31,80	+ 26,17

It is not easy to gauge aright the exact amount and value of invisible exports and imports at any particular moment. The most elusive among them is the purchase and sale of securities between one country and another, being a constantly fluctuating element, partly because of speculation in the stock exchanges of the world, and partly because of the shifting of bills from one centre to another under the influence of varying rates of discount at different centres. Suppose the rate of discount in London is only 3 per cent, while that at New York is 5 per cent. It is cheaper then for a borrower to borrow in London than in New York. A New York borrower is then tempted to do so by drawing what is called a *finance* bill on a London financier, who may have agreed for a consideration to accommodate him by allowing him to draw bills of exchange on him, though he really owes nothing to him. Such a bill of exchange, when accepted by a well-known London financier, is easily turned into cash in the London discount market at the prevailing rate of discount. It can for the same reason be offered for sale in New York just as any commercial bill of exchange, drawn by an exporter of produce in New York on an importer in London. It thus increases the supply of London bills, tends to lower their price, and turn the exchange against London. It is not the *bona fide* borrower alone who resorts to this course when the rate of discount at a foreign centre is low; the *speculator* in exchange finds the course equally profitable to him. If, for instance, the supply of London bills is less, then the demand for them in New York and the London exchange rises, the speculator who expects exchange to go down after a short time will be tempted to increase the supply of London bills by drawing *finance* bills on Londoners. As the price which these bills will fetch in dollars will be more satisfactory to the seller if the discount rate in London is low, the temptation to multiply *finance* bills will increase with every fall in the London discount rate. A low rate of discount in any financial centre thus stimulates the creation of finance bills on it, increases the import of securities from outside, and tends to turn the foreign exchanges against it, and, to the extent that it is a free market in gold, produce an outflow of gold from it.

8. This outflow of gold was a matter of very serious consequences to the trade of a country in pre-war days, when the

great commercial nations of the world were all on a gold basis and so practically used the same currency, gold. Any great depletion of the stock of gold in a country led to a curtailment of credit facilities by banks and note-issuing authorities, whose business required them to keep a proper proportion of cash to demand-liabilities. Adverse exchanges thus threatened to create stringency in the money-market, and led to a sudden withholding of credit facilities to merchants and traders who trade largely on credit.

No country could therefore afford to leave its exchange entirely unregulated; and different devices were adopted by different countries to prevent a drain of gold in any considerable quantity. England, which in pre-war days was pre-eminently a *creditor* country, attempted to achieve this object by curtailing its short period loans to other countries through a rise in the *market* rate of discount. This was enough to correct adverse exchanges in London, for the balance of accounts of a creditor country like England was, in the absence of any lending operations, *normally* in its *favour*.

The raising of the market rate of discount in London was a comparatively easy matter in days when Bagehot wrote his classic on Lombard Street, for the members of the London discount market then depended upon the Bank of England for the supply of funds to carry on their discount business. A rise in the bank rate compelled the discount market to raise its market rate, for the discounting institutions could not afford to lend at a lower rate than the one at which they borrowed funds from the Bank of England. But in subsequent years, the relative position of the Bank of England and other discounting institutions had changed considerably. Banks, bill brokers, and discount houses in London had then large independent funds of their own, and did not feel themselves compelled to raise their rate of discount merely because the Bank of England raised its own bank rate.

In order to raise the market rate of discount, the Bank of England was often obliged to assume control of the money market by *borrowing* money in it. This step reduced the amount of cash in hand and at the Bank of England, held by other London banks as their first line of defence against a run on them, and compelled them not only to reduce their discounting busi-

ness but also to call in money lent by them to 'bill brokers', their second line of defence, with a view to providing themselves with an adequate cash reserve. The market was thus compelled to raise its rate of discount; in other words, the bank rate became *effective*.

Such, however, was not the case with other gold standard countries. The device of raising the bank rate was, by itself, ineffective against the tendency towards an outward drain of gold produced by adverse exchanges. It had to be supported by other props in order to achieve the object in view. France depended, for the support of its exchange, upon a large gold reserve and a policy of partial suspension of free payments in gold. Germany resorted to the use of these two props, besides keeping in reserve a large holding of foreign bills and credits which were sold in the international market in case of need. Reliance on these devices, especially the last one, was much more marked in the case of countries of less financial strength like Russia, Austria-Hungary and the Scandinavian countries, Sweden, Norway and Denmark. Thus when the money-market of a country was not a creditor in the international world of finance, the Central Bank of that country took special care to become one with a view to placing itself, at short notice, in funds at foreign centres in case of a foreign drain of gold. The only other courses open were, either to hold a large reserve of gold so as to have a surplus always available for export, or to decline temporarily to deliver gold on demand and permit a premium on gold.

The position of India in the money-markets of the world was similar to these lesser countries of Europe: she, too, was a borrower in the international money-market. If she was to adopt a gold standard and regulate its exchange within definite limits, she could only succeed in this object by means of a large reserve in gold or a large holding of foreign securities. This was the *idea* behind the currency changes of the period 1893-1900.¹

9. It may interest the reader at this stage to note the various ways in which attempts were made to 'control exchanges'

¹ For a further treatment of this see Hartley Withers' *Meaning of Money* and J. M. Keynes' *Indian Currency and Finance*.

during the war period. A recent writer (Mr. Gregory) classifies the various methods of exchange regulation actually adopted by European countries as follows :—

(a) *Increase in the means of purchase available abroad :—*

- (1) Appropriation of domestically held securities available for sale in foreign countries.
- (2) Loans abroad from private individuals or Government Banks.
- (3) Export of gold.
- (4) Different prices, i.e., monopolization or regulation of exports and export prices of articles with inelastic demand.

(b) *Decrease in the necessity of payments abroad :—*

- (1) Restrictions on the importation of 'luxury' goods.
- (2) Restrictions on the exportation of capital by the purchase of foreign securities.
- (3) Centralization of exchange dealings by compulsory transfer of foreign currency to a central regulating authority.
- (4) Prohibitions of exports of local currency.

(c) *Regulation of the fluctuations in value of local currency.*

- (1) Rate fixing—'exchange pegging'.
- (2) Penalties for speculation in exchange.

Of these various methods, the most successful was the policy known as 'pegging' the exchanges. Down to about March, 1919, the exchanges of the United Kingdom, France and Italy with the United States were 'pegged'. The Governments of these countries owed large sums of money to America on account of their large American purchases; but the normal means of remittance to New York were not available in sufficient quantity. The supply of *dollar* bills for European export was altogether inadequate; and if an attempt had been made to remit the balance by export of *gold*, European reserves of gold would all have been exhausted. Even then, a huge deficit would still have remained. The Governments of these countries were therefore obliged to resort to some other means of meeting the situation. They organized the export of such securities held by their citizens as were saleable in New York, contracted loans with American firms, and, after the entry of the United

States into the war, with the American Government. ‘ These arrangements did not, indeed, of themselves involve any absolute pegging of the exchange. But the British Government adopted, partly on political grounds, the further policy of offering its borrowed dollars against sterling at the rate of 4·76 dollars to the pound. The result was that private persons having claims to dollars would never sell them, whatever the trade and price position, on better terms than this. The British exchange was pegged absolutely by Government action ; and a similar, though less effective policy was pursued by the other Allied Governments. Even for the United Kingdom the pegging was not exactly at the point of pre-war parity, but it was only a trifle below this.’ ¹

¹ Pigou, *Ec.J.*, Dec. 1920

CHAPTER V

THE GOLD EXCHANGE STANDARD IN INDIA—ITS THEORY, MECHANISM AND EVOLUTIONARY HISTORY

"1. We are now in a position to understand the main features and the underlying principles of the currency system that was established in India during the period 1893-1900.

As stated at the end of the first chapter, the pre-war Indian currency system is commonly described as a *gold-exchange standard*. Its essentials were : (1) the use of two currencies, one for local and the other for international purposes, and (2) a mechanism to maintain the value of the local currency in terms of the international at a certain maximum rate. In other words, for all internal purposes the rupee was the standard in India, but for external purposes, i.e. for payments abroad, *gold* was available in pre-war days at an approximately constant rate in terms of rupees. Its special features then were : First, that the actual medium of exchange (was) a local currency distinct from the international currency ; second, that the Government (was) more ready to redeem the local currency (rupees) in bills payable in international currency (gold) at a foreign centre (London) than to redeem it outright locally ; and third, that the Government having taken on itself the responsibility for providing local currency in exchange for international currency, and for changing back local currency into international currency, when required (had to) keep two kinds of reserves, one for each of these purposes.¹

The system thus involved an attempt to divorce the value of the rupee from the value of the silver in it, and to regulate it artificially at a constant rate in terms of the British sovereign. This, as we have already shown, was impossible so long as India had 'open mints'. The first step in the direction of giving an artificial value to the rupee was, therefore, to close the mints to the free coinage of silver. This was done in 1893 in

¹ J. M. Keynes.

accordance with the recommendations of a Royal Commission presided over by Lord Herschell. Since then, the value of the rupee has not depended on the market value of its silver contents.

Through the operation of certain forces which we shall examine later on, the value of the rupee rose gradually, in relation to gold, from 13*d.* in 1895, to 15½*d.* in 1898, and to 16*d.* in 1899. From that year onward till 1917, the external value of the rupee was fixed in the neighbourhood of 1*s.* 4*d.*

2. How did Government attempt to prevent a rise in the value of the rupee above this level? Suppose at any time there was a tendency for the rupee-sterling exchange to rise above 1*s.* 4*d.* owing, say, to a favourable balance of accounts. There would then be an increase in the demand of remittance to India, and if the tendency to a rise in exchange was to be counteracted, there must be adequate means of meeting this increased demand. Government provided these in three different ways: (1) It undertook in 1893 to accept in payment of sums due from the public sovereigns and half-sovereigns at Rs. 15 to the pound sterling, and declared in 1899 that sovereigns and half-sovereigns coined at any royal mint were legal tender in India at the rate, one sovereign for Rs. 15. This enabled foreigners to discharge their obligations to Indian merchants by *exporting* sovereigns to India. (2) It further undertook to issue to the public through the Controller of Paper Currency and the Mint Masters, currency notes and silver rupees in exchange for gold coin and bullion at the rate of 1*s.* 4*d.* the rupee, or fifteen rupees to the pound sterling. In effect this amounted to an undertaking on the part of Government to supply an unlimited quantity of rupees at this rate, and so the value of the rupee could not possibly go appreciably higher than this. (3) As the demand for Indian currency came mostly from foreign merchants who imported sovereigns into India only to exchange them into rupees, Government came forward to offer them rupees *in India* in exchange for sovereigns *in London* by selling *Council bills* (i.e. bills drawn by the India Council on the Indian Government) at a rate approximately of a rupee for 1*s.* 4*d.* To some extent, this was convenient both to British merchants and to the Indian Government. It practically amounted to a remittance *in rupees* from the British importer to the seller of Indian produce in India.

Government was thus obliged to provide large *reserves* of rupees in India to meet the 'demands of trade' for Council Bills. These consisted of: (a) The cash balances at the Indian treasuries, (b) rupees in the Paper Currency Reserve in India, (c) the rupee section of the Gold Standard Reserve, built up out of the profits from coinage, and (d) the new coinage from the mints, when necessary. All these measures were calculated to provide adequate means of increasing the supply of local currency to any amount necessary to bring *down* the value of the rupee very *nearly* to 1s. 4d., and proved, till 1917, quite effective in preventing the specific appreciation of the rupee in terms of sterling *above this level*.

3. This, however, was only one side of the problem of rupee-sterling exchange, and by no means the more important one. The motive behind the monetary changes of the period 1893-99 was the desire of Government to prevent a *fall* and not a *rise* in the gold value of the rupee. Suppose the rupee showed a tendency to depreciate in terms of the British sovereign owing to an unfavourable balance of accounts. How was such a situation to be met?

It was obviously unwise at such a moment to continue to sell Council bills in the same volume as before; that would only tend to depreciate further the sterling value of the rupee. (1) The first thing that the Secretary of State had to do in times of weak exchange was, therefore, to support it by greatly *restricting* the sale of Council bills, and, if he could not get at least 1s. 3 $\frac{2}{3}$ d., by *completely withdrawing* from the exchange market. (2) In such a contingency, he had to devise some other means of recovering money from India to meet his expenditure on behalf of India in London. He had to fall back upon his *cash balances* in London, and, if they proved insufficient, on the *gold branch* of the Indian Paper Currency in London. The Indian Government had to transfer at the same time equivalent amounts in rupees to the Paper Currency Reserve in India, in order that the total value of the Indian Paper Currency Reserve *as a whole* might remain the same as before. (3) It was possible that at times even this complete cessation of sale of Council bills might prove insufficient to restore exchange to its old parity, 1s. 4d. On such occasions, Government was to *withdraw rupees* from circulation in India by selling *reverse council bills* (i.e. bills

drawn by the Indian Government on the Secretary of State in London), payable in sterling at the rate of $1s. 3\frac{2}{3}d.$ for a rupee out of India's gold reserves kept in London. This by itself would amount to a process of deflation or a contraction of rupees or notes in circulation in India. The resulting scarcity of Indian currency, other things remaining the same, would therefore tend to restore the value of the rupee back to its parity.

The first set of measures described in para. 2 thus prevented the sterling value of the rupee from rising above $1s. 4d.$ by more than the cost of remitting sovereigns to India, while the second set enumerated in para. 3 prevented it from falling below $1s. 3\frac{2}{3}d.$ In other words, the extreme limits of variation of the rupee-sterling exchange were $1s. 4\frac{1}{2}d.$ and $1s. 3\frac{2}{3}d.$ 'These variations were intended to, and did, correspond to the differences which in normal times constantly occur between actual exchange rates and theoretical par of exchange in transactions between countries, of which both are on a gold standard with free import and export of gold in both directions.'

4. The pre-war Indian currency system, like all other gold-exchange standards, was thus based on the following three principles :—

(1) 'Government control of the amount of the issues, so as to keep them within the demands of trade for legal-tender money.

(2) Acceptance of the coins at their legal value for public dues and private debts.

(3) The sale of drafts at or near par upon gold-exchange funds kept at the financial centre of the world.'

We may now sum up the main features of the pre-war currency system of India as follows :—

(1) The Indian mints were closed to the free coinage of silver, the control over the amount of new silver coinage being exercised entirely by Government.

(2) The British sovereign was unlimited legal tender in India at the rate of £1 to Rs. 15, and was convertible at this rate.

(3) The rupee too remained legal tender without limit of amount, but it was not freely convertible into gold under the law,

¹ Sir Lionel Abraham's *Memorandum A.* before the Babington Smith Committee.

though, as a matter of convenience, Government was sometimes willing to exchange sovereigns for rupees at the rate of £1 for Rs. 15.

(4) The sterling value of the rupee was so regulated as to confine its fluctuations within the upper limit 1s. 4½d. and the lower limit 1s. 3¾d.

(5) With a view to working this system of regulating the value of the rupee, Government became one of the largest exchange dealers in the market, and had to keep two kinds of reserves, the one mainly in rupees and the other chiefly in sterling, the one located in India and the other in London. Both in India and London these reserves were kept in three compartments. The reserves in India consisted of : (a) the Treasury Balances, (b) the Paper Currency Reserve and (c) the Gold Standard Reserve ; the reserves in London included : (a) the India Office Balances, (b) the London branch of the Paper Currency Reserve, and (c) the London branch of the Gold Standard Reserve. Although each of these was created for a specific object, all were available in case of need for the general object of *supporting exchange*, and thus constituted '*practically one single fund.*'¹

5. The foregoing paragraphs must not lead the reader to think that the system described therein was deliberately adopted as a *consistent whole* in 1893 or even in 1899. Like all English institutions, it was 'the result of a series of experiments' extending over a pretty long period. The authorities had no clear idea of the final object to be attained in 1893 or in 1899. The different parts of the system were created at different dates, and the system as a whole was the *final result* of piecemeal changes, brought about more by the logic of events than by systematic thinking on the part of any particular individual or individuals. It was only in 1913 that these different changes came to be reviewed and examined as parts of a whole ; it is only since then that the authorities came to be finally committed to the maintenance of the gold-exchange standard.

A brief history of the currency changes between 1893 and 1910 is therefore necessary for understanding clearly the evolutionary nature of the growth of the system. The first date

¹ Chamberlain Commission.

to note is the year 1892, when a Royal Commission known as the Herschell Commission was appointed to suggest measures for preventing constant fluctuations in exchange, due to the steady fall in the value of silver during the preceding two decades. Its report was submitted in 1893, and, in pursuance of its recommendations, Government closed the Indian mints to the free coinage of silver and issued a notification fixing 1s. 4d. per rupee as the rate at which rupees or notes would be supplied by the Commissioners of Paper Currency and Mint Masters in exchange for gold coin and bullion. In 1898, Government appointed another Royal Commission with Sir Henry H. Fowler, M. P., as Chairman, to consider the results attained by the previous measures, and advise Government as to the policy to be pursued thereafter. Soon after the appointment of the Commission, exchange touched 1s. 4d., and conditions continued so favourable to this rate during the succeeding months, that by the time the committee issued its report, over £4,500,000 of gold tendered in exchange for notes at the rate of 1s. 4d. per rupee, had accumulated in the Paper Currency Reserve in India. This encouraged Government to pass Acts Nos. II and VIII of 1898, authorizing the issue of notes in India against gold held *in London* by the Secretary of State, and ear-marked at the Bank of England as part of the Indian Paper Currency Reserve, and to sell freely council drafts in London to meet the 'demands of trade' for rupees or notes in India. The report of the Fowler Committee approved of the closure of the mints, and decided in favour of fixing the rupee permanently at 1s. 4d. The Commissioners looked forward 'to the effective establishment of a *gold standard and currency* based on the principles of the free inflow and outflow of gold,' and recommended several measures with a view to make an appreciable advance towards that goal. In pursuance of their recommendations, Government passed Act XXII of 1899, declaring sovereigns and half-sovereigns legal tender throughout India at the rate of 1 sovereign for 15 rupees; and set apart in 1900 the profits on the coinage of rupees, to form a special reserve subsequently known as the Gold Standard Reserve. Contrary to the idea of the Fowler Committee, the reserve was, however, located not in India but in *London*. Although gold coins were now legal tender in India and Government made an active effort to induce people to use

sovereigns as a medium of circulation, the public continued to demand rupees, and eventually forced Government to *resume* the coinage of rupees in 1900. This fresh coinage necessitated recourse to the London silver market, and Government asked from the Legislature temporary authority to use the gold held in the Paper Currency Chest in London, for the purchase of silver for coinage, and to treat the silver so purchased as part of the reserve against notes in circulation during the interval between purchase and mintage. Act IX of 1902 made this arrangement permanent. In 1904, the continuous demand for rupees in India was met by a notification of the Secretary of State, signifying his willingness to sell Council bills on India at *ls. 4½d. the rupee without limit*. In 1905, further demand for rupees made it necessary to provide the Secretary of State with sufficient sterling resources in London to be utilized for the purchase of silver ; and this was done by shipping to London 5,000,000 sovereigns out of the accumulated stock in the Paper Currency Reserve in India to be held as part of that reserve in London. In 1906-07 the need of providing larger reserves of rupees in order to meet the increasing demand for remittance to India, led Government to institute the rupee branch of the Gold Standard Reserve, which thenceforward consisted of two portions, one held in sterling in London, the other in rupees in India. So far, the Indian currency system had met with only fair weather ; but a partial failure of the summer monsoon in 1907 caused the Indian exchange to be weak in November 1907. Government was then obliged to have recourse to all the expedients described in a preceding paragraph for preventing a fall in the value of the rupee, including the sale of reverse council bills or sterling drafts on London at *ls. 3⅔d. the rupee*. The system had by this time developed all the essential features of a gold exchange standard, and came as such under the searching examination of the Chamberlain Commission in 1913. The report of the Commission endorsed generally the policy and principles underlying the establishment of the gold-exchange standard in India, but made important recommendations regarding 'the use of gold as currency, the minting of gold in India, the development of note-issue, the utilization of Government balances, the sale of drafts on India and London, the constitution and location of the Gold Standard and Paper Currency Reserves, the organi-

zation for the discharge of financial business at the India Office, and the question of establishing a State or Central Bank in India.' While these recommendations were still under consideration war broke out, and 'it was decided to postpone further action until the return of normal conditions.'

CHAPTER VI

THE INDIAN EXCHANGE MARKET

1. We have examined in chapter iv the natural forces that cause fluctuations in exchange, and noted in chapter v the fact that exchange between India and England in pre-war days was not left merely to the automatic working of these natural forces, but was regulated by Government. It attempted to fix the upper and lower limits of the rupee-sterling exchange by entering the exchange-market whenever the price of sterling rose above or fell below certain points. In practice, this amounted to regulating not merely the exchange between India and England, but also within limits that between India and other foreign centres, for most of the transactions in foreign trade were either settled in sterling or passed through London, the clearing-house of the world in pre-war days. The rupee-sterling exchange was then the dominating factor in the Bombay or Calcutta exchange with all foreign commercial and financial centres, and was therefore the only exchange in which practical business men felt themselves interested.

2. Let us now glance at the constituent members of this rupee-sterling exchange market. As already explained in a previous chapter, it consists of buyers and sellers of sterling bills in India. Among the former, we have already mentioned the importers of merchandise who have to pay for their imports. Next, we have the exchange banks and bullion dealers who import specie in India and pay for it in London; thirdly, there is the group of miscellaneous people who on various grounds have to remit money to London; and lastly there is the Government which figures as a buyer of sterling when it takes over imported specie or when it cashes the Secretary of State's Council drafts. Similarly sterling bills are sold by (i) exporters of Indian produce; (ii) exchange banks and bullion dealers when they export specie; (iii) importers of funds from England into India; and (iv) Government when it sells Reverse Councils. As the most important of the members enumerated above are (1) the exchange banks and (2) the Government, the part played by each deserves a somewhat detailed description.

3. Like all other banks, the exchange banks receive deposits, grant loans, and deal in overdrafts and discounts. But the characteristic part of their business, and the one which distinguishes them from other banks, consists in their financing India's foreign trade and dealing in Indian exchange. They employ a large part of their funds in purchasing or discounting bills of exchange, particularly those which are drawn against export trade. These are of two kinds: (1) The 'documents against acceptance' (D-A's), i.e., the documents which will enable the buyer of goods to get the goods out of the shipper or the warehouse of a bank, on his 'accepting' the bill; and (2) bills against which the documents will be given up only on payment (D-P's). They are usually drawn at three months' sight. As the exchange banks generally discount far more of these bills than their own funds would warrant, they have to obtain the necessary additional cash in London by rediscounting the D-A's in London. They experience no difficulty in this matter, as these bills are generally drawn on, and accepted by, well-known London houses. The bulk of the Indian export trade is thus financed by funds borrowed from the London money-market.

The London branches of these banks deal also in bills negotiated in London and drawn on Indian importers. As a rule, these bills are not rediscounted, the exchange banks using their own funds to finance the import trade.

As in pre-war days India had usually a favourable balance of trade, and bills against exports exceeded those against imports, the exchange banks were very often in possession of larger funds in London than they could utilize there in financing India's import trade. These surplus funds were needed badly in India for the purchase or discount of export bills; and so they remitted them to India by (1) buying the Secretary of State's Council bills, giving sterling in London in exchange for rupees in India; and (2) shipping to India sovereigns or bullion (gold or silver) in large amounts.

4. These exchange banks were the best customers for the Secretary of State's Council bills. Although himself one of the largest dealers in exchange, he did not compete with them for business in Indian exchange. He conducted his exchange business not *directly* with the trading public but only *indirectly* through the exchange banks. He was their ultimate source of

supply for bills on India. His council bills, when sold below the rate at which it was profitable to ship sovereigns or specie to India, provided them with easy means of transferring their funds from England to India.

The procedure followed by the Secretary of State in selling these council bills in pre-war days is described by the Chamberlain Commission as follows: 'On each Wednesday, a notice is exhibited at the Bank of England inviting tenders to be submitted on the following Wednesday, for bills of exchange and telegraphic transfers on the Indian Government authorities at Calcutta, Madras, and Bombay. The notice states a limit which the aggregate amounts will not exceed. The Secretary of State does not bind himself to allot the whole amount mentioned in the notice, and as a matter of practice does not accept any applications at a price lower than $1s. 3\frac{1}{2}d.$ for transfers. The price charged for telegraphic transfer is ordinarily higher by $\frac{1}{2}d.$ per rupee than that charged for bills, but when the Calcutta or Bombay Bank rate exceeds 8 per cent, tenders for transfers rank for allotment with tenders for bills only if they are $\frac{1}{4}d.$ higher. Allotment is made to the highest bidders, and when the total amount exceeds the amount offered, allotment is made *pro rata*. When the tenders received on Wednesday have been dealt with, the amount to be offered for tender on the following Wednesday is decided upon, the main consideration being the requirements of the India Office, and the strength of the demand. "Intermediate" or "special" bills and transfers can be obtained on other days of the week at a price fixed by the India Office at not less than $\frac{1}{2}d.$ higher than the lowest prices at which allotments have been made on the preceding Wednesday, the exact rate and the maximum amount of such "intermediate" being fixed for the week each Wednesday.'

It will be seen from the above that the price charged for telegraphic transfers was usually $\frac{1}{2}d.$ per rupee higher than that for bills. The reason for this is easy to understand. The bills could not be changed into rupees at Calcutta, Bombay, or Madras for about a fortnight after the sale, on account of the time taken by the mail; but 'telegraphic transfers' could be encashed in India only a few hours after the Secretary of State received their sterling price in London. The purchaser of a telegraphic transfer thus obtained his rupees in India a fortnight

earlier, and was on that account asked to pay for this privilege a sum equal to 5 per cent on the money for a fortnight, i.e., about $\frac{1}{32}d.$ per rupee. If, however, the rate of interest in India at any time exceeded 8 per cent, he was made to pay $\frac{1}{8}d.$ per rupee, i.e., approximately the interest on a rupee for a fortnight at the rate of 10 per cent.

What determined the amount of the council bills sold by the Secretary of State for India? Government policy, in this respect, has varied from time to time with the change of ideas regarding the object of council bills. Up to the year 1898, this weekly auction of council drafts was nothing more than a cheap and simple means of remitting money to the India Office on account of various items (including interest on the public debt of India, pensions and furlough allowances of retired civil and military officers, purchase of stores in London on behalf of the Indian Government, expenditure of the India Office, etc., etc.) known collectively as the 'Home charges'. Till then, the volume of the council bills sold was mainly determined by the amount required to defray the Home charges, though occasionally the Secretary of State took advantage of a favourable rate of exchange to transfer to London more than was needed for this purpose. 'But the system existed simply as a means of remitting to London so much of the Government balances as it was desirable to make available in London. Its main justification lay in the fact that it was both effective and profitable to the Indian Government, and convenient to trade in providing a ready means of selling a large part of the debts due by people in this country (England), and elsewhere, to people in India for the surplus of exports over imports.'¹

After 1898, the function of these council bills was enlarged; and, as already explained in chapter v, they became a very important part of the general mechanism for the maintenance of the gold-exchange standard. They were thereafter used as a means of preventing the inflow into India of sovereigns and their re-export by Government to London, either for the purpose of purchasing silver for fresh coinage of rupees, or to 'avoid the useless accumulation of gold in the Paper Currency Reserve in India.' Suppose India had in any year a favourable balance of

¹ Chamberlain Commission.

trade, and sovereigns flowed into it and were presented at the Government treasuries for encashment into rupees or notes. Government would then be obliged to mint more rupees; the silver needed for this purpose would be purchased in London; and sovereigns would have to be shipped back to London, either to pay for this silver, or to be credited to the Gold Standard Reserve there as profits from new coinage. To avoid this double loss—the cost of sending gold to India and the expense of bringing it back to London—the Secretary of State considered it necessary ‘to sell sufficient drafts, not merely to meet his own requirements on revenue and capital account, but also to satisfy the *demands of trade* up to such an amount as will enable the balance of trade in India’s favour, over and above the amount of Home charges on revenue and capital account, to be settled without the export to India, on private account, of more gold than is actually required in India for absorption by the public.’

Thus the council drafts were ‘sold *freely*’, that is to say, as long as there was a demand for them and as long as it could be met from the rupee resources of Government.

In 1913, the Chamberlain Commission was asked by various witnesses to consider various limitations on the amount of council bills to be sold, and to lay down a rule for future guidance. They rejected the suggestion that the Secretary of State should *never* sell more than the amount of his Home charges, or that he should adjust the sales in such a manner as always to keep his cash balances from rising much above the working figure of £4,000,000. Nor did they approve of the principle that the *demands of trade* should be the only determining factor in the volume of the council bills sold. Their view was that the extent of the sale of the council drafts should depend on the ‘*requirements of Government*, whether *immediate or prospective*, for funds in London’. Though they recognized that *convenience of trade and regulation of exchange* were important considerations for the India Office in the management of this system, they thought that in some of the official explanations on the subject, too much stress had been laid upon these aspects and too little attention given, to the *primary* and by far the most important function of the council drafts, namely, the transfer to London from India of public funds to meet the requirements of the Secretary of State in London. And they came to the conclusion that ‘*the*

interests of trade were in themselves no justification’ for selling council drafts in excess of the Secretary of State’s needs, immediate and *prospective*; for if, to accommodate trade, the Secretary of State were actually to go beyond this standard, ‘it would mean that he would bring to London money for which he had no need and that sooner or later he would have to send it back to India!’

It is evident from what has been said above, that in pre-war days the volume of council bills depended, partly at any rate, upon the discretion of the Secretary of State. But he was not in the position of a monopolist who could, by limiting the supply of a commodity, dictate his own price; for the council bills were not the *only* means of making remittances to India. As the British sovereign was legal tender at the rate of Rs. 15 per sovereign, the export of sovereigns to India provided an alternative mode of remittance. The price of council bills could not therefore exceed the equivalent amount of sovereigns (calculated at the rate of Rs. 15 per pound) plus the cost of sending sovereigns to India. In pre-war days, this cost did not generally go beyond $\frac{1}{8}d.$ per rupee; and so the maximum value of the rupee was then 1s. $4\frac{1}{8}d.$ But sometimes this cost was a good deal less than $\frac{1}{8}d.$; and as it depended upon a number of variable factors governing its component items (insurance, freight, and interest during the period of transit), it was not always easy to say exactly at what price the export of gold to India would become a serious competitor of bills as a means of remittance. Occasionally, sovereigns in transit from Australia to London or those ready for export from Egypt, were bought by the banks as the cheapest form of remittance to India, and the Secretary of State was obliged to cut down his price of council bills owing to this competition.

The Secretary of State, then, was the largest dealer in the rupee-sterling exchange market, and was able to some extent to control the level of this exchange by regulating his sales of council bills. But these bills were not the only means of adjusting India’s trade balances. The precious metals played in this adjustment a part only a little less important than council drafts, as can easily be seen from the following table (given in the Babington Smith Committee’s Report) indicating the balance of trade on private account, the net imports of treasure on

private account, and the sales of council drafts for the period 1904-1914 :—

Year	Excess of exports over imports on private account	Net imports of treasure on private account (gold and silver coin and bullion)	Net sales of council drafts (i.e., council drafts less Reserve drafts)
	Rs.	Rs.	Rs.
1904-5 ...	4,05,48,200	1,67,00,600	2,41,50,000
1905-6 ...	3,90,86,700	98,46,900	3,18,86,000
1906-7 ...	4,55,06,600	1,44,20,000	3,40,69,400
1907-8 ...	3,16,40,000	1,82,53,300	1,56,76,700
1908-9 ...	2,11,73,300	1,11,16,300	53,35,300
Total ...	17,79,54,800	7,01,37,100	11,11,17,400
1909-10 ...	4,72,13,000	2,06,88,000	2,77,10,600
1910-11 ...	5,36,85,300	2,17,00,000	2,63,89,800
1911-12 ...	5,95,12,900	2,87,06,000	2,69,17,500
1912-13 ...	5,70,20,900	2,94,35,000	2,59,83,500
1913-14 ...	4,37,53,900	1,97,13,000	3,12,00,800
Total ...	26,11,86,000	12,02,42,000	13,82,02,200

CHAPTER VII

THE INDIAN CURRENCY SYSTEM DURING THE PERIOD 1914-19

1. We have so far dealt with the Indian currency system as it existed up to the year 1914 ; we have now to notice the effects of war on it.

At the first shock of war, a sense of insecurity prevailed in the country ; and from the month of August, 1914, to the early autumn of 1915, a general dislocation of trade and business led to weakening of exchange, withdrawals of Savings Bank deposits, demand for conversion of notes, and a scramble for gold. Government met the situation boldly. They supported exchange by selling reverse councils to the extent of £8,707,000 between the 6th August, 1914 and the 28th January, 1915. This greatly restored confidence ; and thereafter for nearly two years the fluctuations of Indian exchange were insignificant. The run on the Savings Banks resulted in the net withdrawal of over 8 crores of rupees during the year 1914-15 ; but the promptness with which Government met all claims soon restored confidence, and the tide turned in 1915-16, when deposits began to increase again. The abnormal demand for the conversion of currency notes into rupees resulted in a net return of currency notes to the extent of 10 crores between 31st July, 1914 and 31st March, 1915 ; but the steps taken to meet this demand for encashment checked uneasiness, and the crisis passed away in the spring of 1915. The keen demand for gold in exchange for notes resulted in the loss by Government of about £1,800,000 of gold between the 1st and the 4th of August, 1914, and forced Government to suspend the issue of gold to the public from the 5th August, 1914.

On the whole the disquieting symptoms lasted only for a short period, and with the restoration of confidence the Indian Government found it unnecessary to have recourse either to the expedient of a moratorium or to the inconvertibility of the note-issue, as Governments of many European countries found it necessary to do during the period. The mechanism of the

Indian currency system worked quite smoothly right up to the end of 1916 ; but new complications arose soon after that.

2. Several causes contributed to these new difficulties. In the first place, the balance of trade in India's favour began to increase. Taking the three years, 1916-17, 1917-18, and 1918-19, we find that the average balance of trade in India's favour rose to £59,601,100 as against £53,429,200, the average of the last three years of the pre-war period (1911-12 to 1913-14). This increased greatly the demand for local currency, which was further intensified by exceptional disbursements made by the Government of India on behalf of His Majesty's Government, amounting to over £240,000,000 during the five years, 1914-19.

The Government of India, however, were at this time in a specially unfavourable position for meeting this large demand of currency. There was a marked reduction during the war of imports of gold from Australia and Egypt, which had been important sources of the supply of sovereigns, while gold imports from other countries were checked by the restrictions imposed by the allied Governments. Unlike other creditors of the belligerent Governments, India was not paid in gold for the services she rendered to them. During the war gold in the U.S. federal reserve system increased from \$ 592 millions to \$ 1,786 millions or approximately £250 millions ; the gold in the Spanish banks increased by £70 millions ; in the Netherlands by £43 millions ; in Switzerland by £10 millions ; and in Norway and Sweden by £14 millions. But the net import of gold into India during the same period was only £26 millions. In other words, countries with a population of 114 millions increased their gold reserves by £387 millions, while India, with a population nearly three times as large, was allowed to have in the same period only £26 millions.

At the same time, there was a heavy decline in the net imports into India of *silver* coin and bullion on private account. They fell off from a total of £24 millions in the pre-war quinquennium to less than £10 millions during the five years, 1914-15 to 1918-19. The burden of liquidating India's favourable balance of account therefore fell wholly on the supply of rupees or notes by the Indian Government through their sales of council bills. They were obliged to make heavy purchases of silver and set the mints actively to work. But during this period, the silver

market of the world was subject to conditions of supply and demand very unfavourable to purchasers of silver. There was, in the first place, a marked decline in the world's production of white metal, the average for the four years, 1914-17, being only 178,075,000 fine ounces, as against an average of 228,552,000 ounces for the four years, 1910-13. In the second place, the world demand for silver, particularly for coinage, was unusually keen. These causes combined to send up the price of silver from 27½*d.* per standard ounce in 1915, to 35½*d.* in April, 37*d.* in December, 1916, and 43*d.* in August, 1917—a point at which the exchange value of the rupee at 1*s.* 4*d.* was equivalent to its bullion value. In September, 1917, the United States Government attempted to arrest the rising tendency of silver prices by prohibiting the export of the metal except under licence, but in spite of this control, the London price of silver ranged between 47¾*d.* and 50*d.* per standard ounce between May, 1918, and April, 1919.

3. In these circumstances, Government was unable to meet the heavy and continuous demand for silver coin without considerable loss at the customary rate of exchange, and were therefore driven to the conclusion that the maintenance of the pre-war currency and exchange system was impracticable. The situation was met by resorting to exceptional measures. (1) The Secretary of State withdrew his offer to sell council drafts without limit of amount, and limited his sales to a fixed weekly amount, varying between 120 lakhs and 130 lakhs. As this amount was insufficient to finance the whole of the Indian export trade, Government introduced certain measures of control with a view to according preferential treatment to exports required for war purposes. They sold council drafts, not at rates tendered by prospective buyers, but at a fixed rate, determined from time to time by the Secretary of State, and confined these sales to persons on the 'approved list', who were required to do business with other institutions and firms only at prescribed rates, and apply their resources primarily to financing the export of articles required by the Allies for the purpose of war.

(2) In view of the rise in the price of silver to a level higher than that which corresponds to a bullion value of 1*s.* 4*d.* for the rupee, the Secretary of State was compelled to raise, from time to time, the rate at which he sold this limited amount of

his council drafts. The successive steps of these changes in the rate of exchange are shown in the following table :—

Date of introduction			Minimum rate for immediate telegraphic transfers	
			s.	d.
3rd January, 1917	...	...	1	4½
28th August, 1917	...	...	1	5
12th April, 1918	...	...	1	6
13th May, 1919	...	...	1	8
15th September, 1919	...	...	2	0
22nd November, 1919	...	...	2	2
12th December, 1919	...	...	2	4

4. In addition to these fundamental changes, several supplementary measures were taken to enable Government to cope with the heavy demand for currency and to conserve adequate metallic resources for this purpose. On June 29, 1917, an Ordinance was issued requiring all gold imported into India to be sold to Government at a stated price, based on the exchange value of the rupee, and declaring the use of silver or gold coin for other than currency purposes as illegal. On September 3, 1917, Government prohibited the export of silver from India, as also its import on *private account*. The use of silver was further economised by the issue of 2½-rupee notes in December, 1917, of one-rupee notes in January, 1918, and of a new two-anna nickel coin in March, 1918. But all these measures proved insufficient for the needs of the situation. The demand for currency continued unabated ; and Government had no option but to rely more and more on their issue of paper currency as a means of satisfying the insistent demand of the country for currency. This course brought the country almost to the verge of inconvertibility. In April, 1918, the position at Bombay became very critical. Rupees were pouring out to finance the cotton crop at fanciful prices. Bad news from France brought a run upon our currency offices by timid holders of our notes. Our visible reserve of silver had dwindled to insignificance, and for several days the maintenance of specie payments hung in the balance. The crisis was averted only by the diplomacy of Lord Reading, who induced the United States Government to sell to India 200,000,000 fine ounces of silver at 10½ cents per

fine ounce—a supply of silver which represented considerably more than the world's annual mine production since 1914.

The period 1916-19 is marked by several other changes in the Indian currency system. A branch of the Royal mint was opened at Bombay (August, 1918) for the coinage of sovereigns from gold tendered to the Deputy Master by the Government of India. The Indian paper currency system underwent substantial modifications, which we have already noticed in chapter iii. Besides a complete departure from the pre-war system of free and unlimited sales of council drafts referred to in a previous paragraph, two minor changes were made in the system of council bills. The sales were made on Tuesdays instead of Wednesdays; and a system of 'deferred drafts', payable sixteen days after the departure of the weekly mail, introduced for the first time shortly after the outbreak of war owing to the uncertainty of mails, proved so convenient to the public as entirely to replace 'bills' throughout the period.

The war left its marks on the composition and the total amount of the Gold Standard Reserve also. We have already dealt with the history of this reserve in chapter v, noticing how it was built up out of the profits of rupee coinage and located partly in London and partly in India, and explaining the part it was intended to play in the working of the gold exchange standard. Its composition on March 31, 1913, was as follows:—

	£
Gold in London	1,620,000
Do. India	<i>Nil.</i>
Silver in India branch : 6 crores at 1s. 4d.	4,000,000
Securities at market value ...	15,945,669
Money lent at short notice ...	1,005,664
Total ...	22,571,333

The Chamberlain Commission were of opinion that the proper place for the location of the *whole* of this Reserve was London, as 'London is the clearing-house of the world, India's chief customer is the United Kingdom, and London is the place where money is required both for the expenditure of the Secretary of State on India's behalf and for payment of India's commercial obligations to this country (England) and the world in general.'

The *rupee* branch of the Gold Standard Reserve was therefore abolished in August, 1915. The Commissioners had further recommended that a *substantial* portion of the Reserve should be held in *actual gold*, for 'the realization in a crisis of securities in large quantities, and even the calling in of sums lent out at short notice, are likely to cause some stringency in the London market, and if the exchange crisis in India which makes such realization necessary is accompanied or directly caused by a financial crisis in London or reacting upon London, as is very probable, the difficulty of realization may be accentuated, and the possibility of loss to India cannot be ignored.' Disregarding this recommendation, Government allowed the percentage of gold to the total Reserve to fall from 24% in 1915 to only 3% in 1917, and to almost *nil* in 1919. On November 30, 1919, it was constituted as follows, the figures given representing in each case the face value of the security :—

	£
Cash	27,093
British Treasury Bills, maturing between December, 1919, and March, 1920 ...	8,219,000
Exchequer Bonds redeemable between February, 1920 and October, 1921 ...	16,199,300
National War Bonds, redeemable 1st October, 1922	7,500,000
Five Per Cent War Loan, 1929-47 ...	3,762,181
Local Loans 3% Stock	200,000
Irish Land Stock, 2½%	438,720
Transvaal Government Guaranteed Stock 1923-53	1,092,023
Total ...	37,438,317

CHAPTER VIII

INDIAN CURRENCY AND EXCHANGE IN 1920-23

1. The events described in the last chapter were the subject of examination by the Babington Smith Committee, which was appointed on May 30, 1919, with the following terms of reference : ' To examine the effect of war on the Indian exchange and currency system and practice, and upon the position of the Indian note-issue, and to consider whether, in the light of this experience and of possible future variations in the price of silver, any modifications of system or practice may be required ; to make recommendations as to such modifications, and generally as to the policy that should be pursued with a view to meeting the requirements of trade, to maintaining a satisfactory circulation, and to ensuring a stable exchange standard.' The Committee submitted its report on December 22, 1919; and Government issued in February, 1920, several notifications in order to give effect to its main recommendations. The official exchange value of the rupee was now raised to 2s. gold, which was then different from 2s. sterling, as the English paper pound had not returned to its pre-war parity with gold ; in other words, the rupee was declared to be equivalent to 11·30016 grains of fine gold. It was further announced that council drafts and telegraphic transfers would be sold weekly by open tender at competitive rates, with a minimum rate which would vary with the cost in sterling of shipping gold to India so long as sterling was not equivalent to gold, and that in future Reverse Councils would be sold in India during periods of exchange weakness at a rate based on the cost of shipping gold from India to the United Kingdom.

2. The policy of maintaining a 2s. gold rate would, even in the most favourable circumstances, have proved a difficult, if not an impossible, task ; but circumstances at the time when the new policy was put into force were anything but favourable. In January, 1920, a change in India's balance of trade had become evident, and exchange had fallen below 2s. 4d., the level of December, 1919. There were other abnormal circumstances at

work, which should have made the then Finance Member shrink from this policy. His predecessor had warned the Council in his last budget speech that there was at that time 'evidence of a considerable accumulation of funds seeking temporary investment in India in preference to remittance to England'—funds, which 'any threat of a fall in exchange would bring out for remittance purposes.' It was also a matter of common knowledge in commercial circles that the rash type of India merchant had placed heavy orders for imported goods of every kind and that, when these goods arrived in India, there would be a heavy demand for remittance to London. As ill-luck would have it, just when this new policy was decided upon, the London-New York exchange appreciably weakened and the *sterling* fell in terms of *gold*. The result was that the rise in the rupee-*sterling* rate required to give practical effect to the Committee's recommendations was far steeper than what the Babington Smith Committee could have anticipated. Moreover, the *normal* parity of exchange as determined by Professor Cassel's formulae was roughly only 1s. 4d. *gold* in March, 1920, the purchasing power of both the Indian rupee and the American dollar in terms of commodities having fallen to a trifle less than half of what it was in 1913-14. But, unmindful of these warnings, Government persisted in its policy, and attempted to influence the exchange rate by the sale of a limited amount of Reverse Councils at rates based on the American cross-rate, in the belief that the balance of trade would soon swing back in India's favour. But the tide had really turned the other way, and owing to various causes the normal tendency to a favourable balance of trade was being completely reversed. Imports had increased owing partly to the increased demand for piece-goods, the stock of which had run low at the end of the war, and partly to the stimulating effect of the rise in exchange on demand. Exports, on the other hand, had declined owing to a combination of adverse circumstances. In the first place, Japan, one of the chief buyers of Indian cotton, was obliged to reduce her purchases because of a financial crisis there. Secondly, the demand for jute, hides, and tea fell off partly because of the large stocks accumulated in England and elsewhere, and partly because of the industrial uncertainty prevalent in the markets for these goods. Thirdly, India lost some of her best customers. Owing to various economic

and political troubles, the countries of Central Europe were not then in a position to pay for what they wished to purchase ; to use the words of the then Prime Minister, they were ' like a starving man in rags looking through a shop-window at commodities which he badly needs but for which he has not the money to pay.' In the United States, the deliberate action taken by the Federal Reserve Banks to check speculative trading and to lead the way to a lower level of prices, tended to reduce American purchases of India's products. All these circumstances combined to reverse the normal tendency to a favourable balance of trade. The extent of the change may be realized by comparing India's trade returns for August, 1919, with those for August, 1920. Imports in the former period amounted to 16 crores and exports to 27, leaving a net balance of 11 crores in India's favour. In August, 1920, however, imports jumped up to 31 crores, and the exports fell off to 20 crores, thus producing an unfavourable balance of 11 crores. The monthly figures of private exports and imports of merchandise, detailed below, show that the adverse balance of trade began in June and was greatest during the period from October to January :—

(In crores of rupees)

				Imports	Exports	Excess of exports over imports and of imports over exports
April	1920	...	...	22	28	6
May	"	...	...	24	28	4
June	"	...	...	26	23	— 3
July	"	...	...	28	21	— 7
August	"	...	...	31	20	—11
September	"	...	...	29	21	— 8
October	"	...	...	32	21	—11
November	"	...	...	32	19	—13
December	"	...	...	32	20	—12
January	1921	...	...	31	19	—12
February	"	...	...	25	18	— 7
March	"	...	...	24	18	— 6
Total ...				336	256	—80

In these circumstances, Government's efforts to enforce the new policy by selling Reverse Councils was bound to fail. To make matters worse, the new policy was not even given a fair trial. The essential idea underlying the sale of Reverse Councils is not so much to provide remittance for the public as to *lock up the local currency and to reduce the volume of circulation in India*. But the Indian Government had not the courage to face the unpleasant consequences of a drastic reduction of the circulation. It did not withdraw notes from circulation to the full extent of the Reverse Councils sold; it practically went on issuing new currency simultaneously with the sale of Reverse Councils. The price-level in India as compared with the external price-levels thus remained practically as high as before; and even on the theory on which the practice of selling Reverse Councils was based, the rupee-sterling exchange could not be raised in these circumstances. The only result of the persistence in the sale of Reverse Councils was a loss of about 35 crores to India.

The Finance Member's action evoked a storm of protest in the country, and was the subject of a debate in the Imperial Legislative Council. The non-official members attacked the Government policy on four different grounds: Firstly, that the sale of Reverse Council Bills was justified only when it was required to adjust the trade balance against India, and that this contingency had not arisen at that time. Secondly, that it was unwise to draw on the Indian Reserve in London in the conditions then existing, as there were no inflated treasury balances with the Secretary of State, no gold in the Gold Standard Reserve, and very little of it in the Paper Currency Reserve. Thirdly, that the course followed was very dangerous as it artificially encouraged export of British capital invested in India. And lastly, it was urged that the transfer of capital put a strain on the money-market, reduced the value of Government securities, and raised the rate of interest at a time of the year when money was required to move our exports. The Finance Member in reply contended that his policy was an effort in fact to maintain exchange as near as possible to the *gold-point*, that as there was a genuine demand for remittance on the part of companies for the purchase of machinery over and above remittances to pay for imports, it was exceedingly difficult to separate the speculative from the genuine demand for remittance, and that in case

the Reverse Councils were withdrawn entirely we should have neither a gold standard, nor a gold exchange standard, nor any kind of standard at all.' In fairness to the Finance Member, it must be admitted that, so far as the *principle* of selling Reverse Council Bills was concerned, he had practically no alternative if he was to make an effort to maintain the gold-exchange standard at all. But that did not justify his alarm at drastic *deflation*, nor the *rate* at which he sold the sterling drafts. In fact, he himself was forced to admit that the difference between the market rate of exchange and the official rate at which Reverse Councils were sold incited 'people to make their remittances to England as quickly as possible, rather than spread them out throughout the year, as they would otherwise have done', and promised in the end to take steps to bring the two rates together. The truth is, that the gold-exchange standard had broken down under the stress of abnormal circumstances in the post-war period, and it was futile to make any effort to maintain it in the most unfavourable circumstances.

3. The adverse balance of trade prevailed almost throughout the year 1920; nor did the following year bring any change for the better. Both the external and internal factors in 1921 were unfavourable to Indian exchange. In spite of satisfactory rains, prices of wheat and other food-stuffs remained at record heights, and it was not found possible, except in the case of Burma rice, to relax the existing control over export. Labour troubles at the collieries curtailed the raising of coal; and Indian railways were obliged to purchase the foreign coal at greatly enhanced prices. The external conditions were likewise adverse. There was a progressive deterioration in the economic and currency position of the greater part of Europe, and little progress was made with the various schemes for providing credit for impoverished countries. The fall of prices in England, and the depression in Russia and Central Europe, aggravated by famine conditions in the former country, deprived India of her best customers; and Indian exports, which had reached their height with 31 crores in March, 1920, declined to 18 crores in March, 1921, and reached their lowest point in June, 1921, with 16 crores. 'The most serious falling-off was in the exports of yarns and textile fabrics, which were 26 crores less than those of the previous year; the jute industry suffered the worst,

exports of gunny bags totalling only 13,92 lakhs as compared with the previous year's total of 23,91 lakhs, and export of gunny cloth being valued at 15,92 lakhs as compared with 28,54 lakhs.' The net result for the year was that imports exceeded exports by 23 crores, as compared with 79 crores in the previous year. The following table (taken from the Report of the Controller of Currency, 1921-22) compares India's visible balance of trade during the three years, 1919-20, 1920-21 and 1921-22, with the average of the five years preceding the war and of the five years of the war :—

(in lakhs of rupees)

	Average of 5 pre- war years ending 1913-14	Average of 5 war years ending 1918-19	1919-20	1920-21	1921-22
Balance of trade in merchandise (pri- vate)	+ 78,27	+ 76,34	+ 1,25,99	- 79,26	- 22,82
Balance of transac- tions in treasure (private)	- 36,07	- 10,80	- 10,82	+ 1,36	- 12,17
Balance of remittances of funds	- 42,62	- 30,14	- 19,85	+ 27,76	+ 1,26
Total visible balance of trade... ..	- 42	+ 35,40	+ 95,32	- 50,14	- 33,73

Trade conditions were more favourable to Indian exchange in 1922-3. The year marked a distinct advance towards trade recovery. The monsoon was exceptionally favourable and the harvest excellent. And although the unsettlement in the Near East following the Greek reverses in Asia Minor, the removal of Russia from the sphere of the world's commerce, the failure to reach a satisfactory settlement of the Reparations question and the consequent occupation of the Ruhr valley by France, acted as impediments to a full trade recovery, the beginnings of a revival of trade in Great Britain and a marked recovery in America led to a considerable increase in the volume of India's exports. On the other hand, imports into India continued to decrease on account of unfavourable internal conditions, such as the liquidation of the heavy imports of previous years, the failure of a large number of industrial companies, and an orgy of speculation in Bombay. The result

was that the balance of trade began to swing back in India's favour from February, 1922. Its volume was fairly large from April to July, decreased from August to October, and then increased considerably during the remaining months of the year until March, when the balance in favour of India reached 15 crores. The net result of the year was that exports exceeded imports by nearly 82 crores, whereas in the previous year imports had exceeded exports by about 23 crores. And in spite of very large imports of bullion into India, the visible balance of trade during the year was in favour of India to the extent of 28 crores of rupees.

The connection between the course of the rupee-sterling exchange and the relative price levels in India and the United Kingdom during these years is clearly brought out by the following table compiled by Mr. Findlay Shirras:—

Year	Index number Bombay 1914=100	Index number: U.K. 1914= 100 (Board of Trade)	Exchange
1920			
January	231	297	2/4·124
February	219	310	2/8·250
March	211	326	2/4·125
April	224	332	2/3·750
May	217	333	2/1·375
June	222	329	1/9·312
July	220	324	1/11·000
August	217	320	1/10·500
September	218	318	1/9·437
October	210	308	1/7·625
November	204	293	1/6·875
December	192	269	1/5·500
1921			
January	191	251	1/5·875
February	191	230	1/6·875
March	190	215	1/3·160
April	198	209	1/3·375
May	199	205	1/3·687
June	197	202	1/3·312
July	199	198	1/3·500
August	203	194	1/3·750
September	207	191	1/4·937
October	195	184	1/5·437
November	193	176	1/4·437
December	190	171	1/4·000

Year			Index number Bombay 1914=100	Index number U. K. 1914= 100 (Board of Trade)	Exchange
1922					
January	...	...	190	164	1/4·000
February	...	...	186	162	1/3·687
March	...	...	192	160	1/3·219
April	...	...	188	160	1/3·250
May	...	...	189	160	1/3·312
June	...	...	190	160	1/3·687
July	...	...	188	160	1/3·687
August	...	...	186	156	1/3·687
September	...	...	181	154	1/3·562
October	...	...	174	155	1/3·531
November	...	...	176	157	1/3·687
December	...	...	173	156	1/4·000
1923					
January	...	...	180	157	1/4·937
February	...	...	175	158	1/4·187
March	...	...	180	160	1/4·094

These figures show that when prices in Great Britain were as high as in the early part of 1920, the rupee-sterling exchange reached its highest point. When, however, prices in Great Britain were at their lowest about the middle of 1922, the exchange between India and the United Kingdom was at its lowest.¹

4. The trade-returns of the last year show a slow, but sound and steady revival of trade. During the twelve months ending 31st March, 1922, exports exceeded imports by about Rs. 121 crores, as compared with Rs. 82 crores in 1922 and an adverse balance of Rs. 23 crores in 1921. The relative price levels in India and England did not alter very much. The Bombay index number of wholesale prices remained steady at 180 in April, May and June, 1923, declined to 176 in August, rose to 188 in the following December, January and February; and fell to 181 in March, 1922; while the Board of Trade index number of prices in the United Kingdom, which stood at 161 in April, 1922, declined to 155 in August, and rose to 164 in December, 165 in January, and 167 in February, 1922. Under

¹ *Vide* Mr. Findlay Shirras' memorandum read before the Associated Chambers of Commerce.

these conditions the Indian exchange showed on the whole an upward tendency, as will be seen from the following table of the monthly average rates of telegraphic transfers from Calcutta and Bombay on London :—

Year				Calcutta	Bombay
1923					
April	...	...	...	1·4 $\frac{1}{2}$	1·4 $\frac{1}{2}$
May	...	...	...	1·4 $\frac{3}{8}$	1·4 $\frac{3}{8}$
June	...	...	...	..	..
July	...	...	...	..	..
August	...	...	...	1·4	1·3 $\frac{3}{4}$
September	...	...	...	1·4 $\frac{1}{2}$	1·4 $\frac{5}{8}$
October	...	...	...	1·4 $\frac{1}{2}$	1·4 $\frac{7}{8}$
November	...	...	...	1·4 $\frac{3}{4}$	1·4 $\frac{3}{4}$
December	...	...	...	1·5 $\frac{1}{16}$	1·5 $\frac{1}{8}$
1924					
January	...	...	...	1·5 $\frac{3}{8}$	1·5 $\frac{5}{8}$
February	...	...	...	1·4 $\frac{3}{8}$	1·4 $\frac{3}{8}$
March	...	...	...	1·4 $\frac{1}{2}$	1·4 $\frac{3}{8}$

CHAPTER IX

THE PRESIDENCY BANKS AND THE IMPERIAL BANK OF INDIA

1. We may now complete our review of the post-war developments in our currency system by a brief notice of the Presidency Banks and their amalgamation into the Imperial Bank of India on the 27th January, 1921.

The Presidency Banks have a long history behind them. The Bank of Bengal was established as early as 1806, and the Bank of Madras was started in 1843. The first Bank of Bombay was opened in 1840 and dissolved in 1868; but a new Bank of Bombay was formed in the same year (1868). The history of these three banks in their relationship with Government falls easily into four well-defined stages. Prior to 1862, they enjoyed the privilege of issuing notes, but were directly controlled by Government and restricted in the scope of their business by their charters. The second period covers the years 1862 to 1876. In 1862, Government deprived them of the right of note-issue, but relaxed the old statutory limitations on their business, and allowed them under certain agreements of that year to transact the paper currency business as agents of Government, to use Government balances free of interest, and to manage the treasury work at the centres where the banks had branches. In 1866, the agreements were revised and the paper currency business was removed entirely from their control and placed under the direct management of Government. The third period dates from the Presidency Banks Act of 1876, which, amended slightly in 1879, 1899 and 1907, continued to govern them till the formation of the Imperial Bank. Under the provisions of this Act, these banks were confined to a fixed territory, and had to work under rigid restrictions as to the character of their business and the mode of its transactions. For instance, they could not (1) deal in exchange, (2) borrow or receive deposits payable out of India, or (3) lend money for a longer period than six months, or upon mortgage, or on the security of immovable property, or upon promissory notes bearing less

than two independent names, or upon goods, unless the goods or the titles to them were deposited with them as security. At the same time Government abandoned all direct interference in their management, and the banks ceased to enjoy their full use of Government balances, reserve treasuries being constituted at the Presidency towns in which the surplus revenues were drawn. They continued, however, to do a large amount of Government work, such as the management of the public debt and of the treasury work at the Presidency towns and at their branches. This stage came to an end with the passing of the Imperial Bank of India Act in 1920.

In spite of the restrictions imposed upon these banks by Government from time to time, their business expanded at a pretty rapid rate. For instance, their total deposits rose from 640 lakhs in 1870 to 1,476 lakhs in 1890, to 3,234 lakhs in 1910, and to 7,618 lakhs in January 1921. They have become in fact the backbone of the internal banking system, being bankers for Government, and acting, to an increasing extent, as bankers' banks. The following table shows the capital, reserve, deposits and cash balances of these three banks immediately prior to their amalgamation in 1920 :—¹

(in lakhs of rupees)

—	Capital	Reserves	Deposits			Cash
			Public, i.e. Govt.	Private	Total	
Bank of Bengal...	200	210	388	3,439	3,827	1,244
Bank of Bombay	100	125	187	2,650	2,837	980
Bank of Madras...	75	45	124	1,529	1,653	455
Total ...	375	380	699	7,618	8,317	2,679

2. What part do these banks play in financing the internal trade of the country? They do at times make advances to Indian traders against produce or against Government and other approved securities, hypothecated to them; but the form which their assistance to trade usually takes is the purchase or re-discount of internal bills of exchange, known as hundies.

¹ See Mr. Howard's article in the *Economic Journal*, 1920.

How this system actually worked, is described briefly in the following extract from Appendix A to the Report of the Babington Smith Committee :—

‘ The people with whom the bank deals directly are for the most part large *shroffs* of good standing in the principal cities. These men operate with their own capital, and, generally speaking, it is only when they have laid out all their available capital in purchasing the *hundis* of other (and usually smaller) shroffs that they come to the Presidency Bank. The shroffs whose *hundis* the larger shroffs have purchased, have probably also similarly financed other and still smaller shroffs or mahajans, and so on until we get down to the smallest flea of all, namely, the village bania, or grain dealer or goldsmith. For instance, shroff *A* at Amritsar may purchase a bill drawn by a grain dealer upon a Bombay merchant. *A* may endorse the bill and sell it to *B*, a large shroff at Lahore, who sells it to the Presidency Bank, who send it to their Bombay Agency for collection. Or the bill may be a pure finance bill (generally known as a “ hand ” bill as opposed to a “ trade ” bill drawn against produce).

‘ Speaking very generally, it may be said that the Bank’s real security in the matter of purchasing or rediscounting bills is the personal standing of the drawee or endorser or acceptor, and the bank has an elaborate and very efficient system of limits, whereby the amount of bills discounted for each shroff is watched. Put very briefly, the system is as follows : Shroff *A* is given in the bank’s register a limit of, say, 20 lakhs, and at the same time the names of the drawers of the bill purchased from him by the bank are watched. The bank may have purchased from *A*, say, 15 lakhs of bills, the drawers of which are *B, C, D, E*, etc. If it is observed that shroff *A* has been purchasing rather too many bills from shroff *D*, who is of comparatively small standing, or about whom not much is known, *A* will be liable to be turned down, or, if the fact has been noticed by the head office, the branch will at once be told to go slow.

‘ As already mentioned, *hundis* are of two kinds : pure finance bills, known as hand bills, and trade bills. The banks are much more particular as to the amount of the former that they discount for a shroff than the latter. This is not because they receive any documents on account of trade bills (their direct security is just as personal as in the case of hand bills), but because they

know that, somewhere or other, produce or goods exist against the credit so created, that such goods must have been hypothecated to one or other of the shroffs whose names are on the bill, and that, if anything goes wrong, such shroff will be able to realize on the goods and so to reimburse the subsequent holders of the bill, to whom he is liable. In the case of hand bills, on the other hand, it is impossible to say definitely how far these represent a genuine trade demand or not.

‘ . . . It may be said broadly that the *hundi* rate rises and falls with the bank rate proper, though somewhat in advance of it, and naturally so, for one is a discount rate and the other a rate for day-to-day loans. Thus, at the beginning of the busy season, the *hundi* rate would usually be higher than the bank rate, the reverse being the case when the slack season is about to begin; so that the *hundi* rate may be said to be a sort of long-distance signal. When the bank finds that it is not getting enough *hundis* and its money is lying unemployed, it puts down the *hundi* rate; when, on the other hand, it feels that it has already got too much money in the bazaar, or, for some reason or other wishes to consolidate and conserve its resources, it puts up the *hundi* rate, and may even go to the length of refusing to buy new *hundis*. No cases have come to official notice, of a Presidency Bank making a wholesale refusal to renew *hundis*, although it may charge a rate considerably higher than that at which the original *hundi* was rediscounted. On special occasions, when the bank is very hard pressed for money it may impose a prohibitive rate on the bazaar, so as to force shroffs to endeavour to raise money elsewhere rather than to renew their *hundis* with the bank.’

3. Until 1920, these three banks worked independently of one another. The arrangement was highly unsatisfactory from many points of view, the country having no Central Bank, such as existed in most of the other civilized countries of the world. There was no hope of any substantial increase in the number of branches so long as the policy of the Presidency Banks was governed by considerations of territorial limits and of profit and loss, rather than the general development of the country. There was then no institution of commanding position in the country to which the money-market could look forward for help and guidance in a time of crisis. The Presidency Banks were not

strong enough for the task ; while Government had no machinery to bring its reserves into normal connections with banking. As Mr. Keynes put it, ‘ With no Central Reserve, no elasticity of credit currency, hardly a rediscount market, and hardly a bank-rate policy, with the growth of small and daring banks, great increase of deposits, and a community unhabituated to banking and ready at the least alarm to revert to hoarding, even where it had been seemingly abandoned, there were to be found most elements of weakness and few elements of strength.’

Nor was this the only unsatisfactory feature in the situation. Government maintained what is technically called an ‘ Independent Treasury System ’. It is difficult to define this exactly ; there was nothing like it in European countries ; it existed only in the United States, but even there it was in the main a currency, rather than a banking, institution. Omitting all complications of detail, the chief features of the Indian system were : Firstly, the maintenance by Government of several Reserve Treasuries in the three Presidency towns ; secondly, an intimate relation between the operations of the Government in the Currency Department and the movement of funds on trade account, as Government undertook the supply of currency and remittance of funds on wholesale lines throughout the country ; and thirdly, the tendency of the surplus treasury funds to be drawn up towards the treasuries at headquarters. As these treasuries were not a part of the general banking system of the country, there was no regular and normal means of getting rid of the funds thus locked up in the Reserve Treasuries. The only way to send back the currency into circulation was to give loans from the treasury balances. The executive Government was thus invested with power to cause stringency or easiness in the money-market, and the country compelled to maintain two distinct reserves, the Treasury Reserves and the Bankers’ Reserves, with no clearly defined relation between the two.

Lastly, the arrangements stood in the way of a more *elastic* system of note-issue. In absence of a strong Central Bank, the function of note-issue was wholly dissociated from that of banking in India. To discount bills was the function of banks ; but to supply additional currency was the business of the Currency Department. It was difficult to maintain equilibrium

between the supply of notes and the demand for currency under such conditions.

One of the chief peculiarities of the Indian money-market was the enormous range for the normal seasonal fluctuations in the bank rate, because of the scarcity of cash in the busy season and superfluity of funds in the slack months. The high rate in the busy season was not at all an adequate inducement for importing funds from abroad, as the busy season did not last more than three months and the bank rate obtainable on the *average* of the whole year was not at all attractive. The only way to escape from the inconvenience of this high *maximum* rate was to devise some means *within the country* for expanding the currency in the busy season. One easy way of providing this was to lend money from the Government balances *on the security of trade bills* either through the agency of a bank or directly to the money-market. But Government was unwilling to adopt the former course, considering it unwise to transfer the management of Government balances to a *private* bank, while the latter would have taken its officials to a field wholly unfamiliar to them. A still more serious objection against entrusting such a task to a Government department was the likelihood of encouraging the money-market to rely exclusively upon the Government Currency Reserve for relief in times of stringency. 'Whenever the bank rate was very high, there would be a clamour that Government were not lending all they might.'¹

4. The only satisfactory solution of these difficulties was to establish a State Bank in India. The suggestion was an old one; it had been repeatedly pressed upon the attention of Government; and had been shown to be within the sphere of practical politics by two carefully prepared memoranda, one by Mr. Keynes, the other by Sir Lionel Abraham, presented to the Chamberlain Commission. Under Mr. Keynes' scheme, the proposed Central Bank was to perform a variety of functions both in London and in India. Its London office was to be comparatively a small affair. It was not to compete with the Exchange Banks in their remittance business; nor was it to have any direct dealings with the public. It was to deal

¹ J. M. Keynes.

only with the Secretary of State, the money-market, and other banks ; to confine its business to (a) the sale to other banks of drafts and telegraphic transfers payable at its Indian offices ; (b) the re-discount of sterling bills at the Bank of England ; (c) the borrowing for short periods from the Bank of England ; (d) the loaning of funds on the London money-market ; (e) the replenishment of the Secretary of State's funds at the Bank of England ; (f) the floatation of sterling loans on behalf of the Secretary of State ; and possibly also (g) the management of the Secretary of State's sterling and rupee debt in London.

In India it was to have much wider functions. It was in the first place to take up all the functions which the Presidency Banks performed then, with some relaxation of the then existing restrictions. Secondly, it was to manage the note-issue and the Government debt in India. Thirdly, it was to hold all Government balances, including those held in the Reserve Treasuries and in London, with the exception of two small reserves, one with the Government of India, the other with the Secretary of State. Lastly it was to supply its *own* customers with sterling remittance and to re-discount sterling trade bills for other banks. It was not to be entrusted with (1) the management of the Mint ; or (2) the custody of the Gold Standard Reserve.

Mr. Keynes dwelt at length on the advantages likely to result from the establishment of such a bank, and summed them up as follows : ' There are first of all direct advantages to Government. . . . The chief of them may be enumerated :

' (1) The existing " Independent Treasury System ", by which whenever the Government balances are swollen, deliberately or not, large sums are taken off the money-market, is done away with by the removal of the cause of this system, namely, the absence of a large public or semi-public institution with which large balances could be safely and properly deposited, together with the difficulty of employing Civil servants in a policy of discretionary loans out of the balances.

' (2) The objections to holding large sums at loan for short periods in the London money-market are avoided. . . .

' (3) A bank, responsible for the management of the note-issue, has greater opportunities than are open to Government for pushing the circulation of notes and for popularizing them by an increase in the facilities available for convertibility.

‘(4) The responsibility of Government officials for a variety of financial and semi-financial business is greatly reduced by handing over to a bank all questions of balances, note-issue, remittance, and loans on the London market.

‘(5) The Government has at its command the services of officers of the highest position, trained in financial and banking business, instead of Civil servants who, however full of adaptability and intelligence, have been selected and trained mainly for other purposes.

‘(6) A buffer is placed between the Secretary of State and vexatious criticism on small details of financial business.

‘Next come the immediate advantages to the business world :

‘(1) In addition to the partial release of Government balances through their deposit in a central institution, a considerable amount of funds is made available by the reform of the note-issue.

‘(2) The present wide fluctuations of the bank rate and its normal high level in the busy season may be somewhat moderated.

‘(3) The increase of branches, which the union of Government and banking business should promote, would gradually bring sound banking facilities to many parts of India where they are now almost entirely wanting, both directly and by supplying a basis, in reliance on which private and co-operative banking could be built up.

‘(4) The introduction of re-discount facilities, while probably not of the first importance in the immediate future, might greatly aid the eventual development of Indian banking on the most desirable lines which European experience has so far evolved.’

5. Notwithstanding the able advocacy of Mr. Keynes and the authoritative opinion of the Chamberlain Commission that the question deserved ‘the careful and early consideration of the Secretary of State and of the Government of India’, no step was taken in the matter till the year 1920, when an Act for amalgamating the Presidency Banks was passed. This was followed by an agreement for a period of ten years between the Government and the amalgamated banks, signed on the 27th January, 1921. The amalgamation scheme is admittedly a half-measure; the new Imperial Bank differs materially from the one proposed by Mr. Keynes. It has not been invested

with any responsibility for note-issue, though the issue of notes against commercial bills up to the limit of 12 crores, under the Paper Currency Amending Act of 1923, implies the utilization of the machinery of the Imperial Bank. It has not been entrusted with the remittance business of the Secretary of State, although it has been given access to London by the establishment of a London office. Unlike the State Bank proposed by Mr. Keynes, it will be paid for its services in respect of public debt but will not share its profits with Government, though it will have the increased use of Government funds *free of interest*. Nor does its constitution provide for that degree of Government control, which Mr. Keynes considered an essential feature of a State Bank. For the purpose of comparison we give below in two parallel columns¹ the outline constitution of the State Bank proposed by Mr. Keynes and the sections of the Imperial Bank Act of India dealing with its constitution :—

Mr. Keynes' scheme

1. The supreme direction of the Imperial Bank of India shall be vested in a Central Board of *three* members, consisting of the *Governor* of the Bank, who shall be chairman, the *Deputy Governor*, and a *representative of Government* with three or more assessors.

The Governor shall be appointed for a period of five years *by the King on the recommendation of the Secretary of State*.....

The representative of Government shall be *appointed by the Viceroy*

The Assessors shall be the managers of the three Presidency Head officesThe Assessors shall have the right to attend any meeting of the Central Board and to lay their views before it, *but shall not vote*.....

The Deputy Governor of the Bank and Managers of the Presidency Head Offices.....shall be *appointed by the Viceroy* on the nomi-

Imperial Bank Act of India, 1920

1. (A) *Section 24 : Central Board*

(1) The general superintendence of the affairs and business of the Bank shall be entrusted to a Central Board of Governors (hereinafter in this Act referred to as the 'Central Board') who may exercise all powers and do all such acts and things as may be exercised or done by the Bank and *are not by this Act expressly directed or required to be done by the Bank in general meeting*.

(B) *Section 28.*

(1) The Central Board shall consist of the following Governors, namely :—

(i) The Presidents and Vice-Presidents of the Local Boards established by this Act.

(ii) The *Controller* of the currency for the time being or such other officer of Government as may be *nominated*

¹ The italics throughout are mine.

Mr. Keynes' scheme

nation of the Governor of the Bank and of the Government representative on the Central Board. But the appointment of a Manager to a Presidency Head office shall be subject to the approval of the Presidency Board (including representatives of the shareholders) of the Head office in question.

Within the limits of the Bank Act, *the Central Board shall have absolute authority.....save that the representative of Government shall have discretionary power (for use in emergencies only) to suspend the carrying into effect of any decision until it has been reported to the Viceroy, with whom shall be an ultimate right of Veto.*

Imperial Bank Act of India, 1920

by the Governor-General in Council to be a Governor.

- (iii) Such number of persons, *not exceeding four* and not being officers of Government, as may be *nominated by the Governor-General in Council.* Such persons shall hold office for one year but may be renominated.
- (iv) The Secretaries of the Local Boards established by this Act.
- (v) Such number of Managing Governors, *not exceeding two, as may be appointed by the Governor-General in Council* after consideration of the recommendations of the Central Board.....
- (vi) If any Local Board is hereafter established under the Act, such number of persons to represent it as the Central Board may prescribe.

(2) *The Governors specified in clause (ii) and (iv) and any Governors appointed under clause (vi) of the sub-section (1) shall be at liberty to attend all meetings of the Central Board and take part in its deliberations, but shall not be entitled to vote on any question arising at any meeting.*

(C) Section 10 of the Act empowers the Governor-General in Council 'to issue instructions to the Bank in respect of any matter which, in his opinion, vitally affects *his financial policy* or the safety of Government balances', and to terminate the agreements with the Bank,

Mr. Keynes' scheme

II. Each Head office shall be under the direction of a Presidency Board, consisting of the *Manager* (who shall be the chairman and have the casting vote), the *Deputy Governor*, a *representative of the Local Government*, and *three (or four) unofficial members*.

The unofficial members shall be *elected* by the shareholders on the local register of each Presidency from amongst their own number.

Imperial Bank Act of India, 1920

in case the *Bank disregards such instructions*.

Section 31 requires the *approval of the Governor-General in Council to any by-laws* made by the Central Board under the Act.

II. (A) Section 25.

Local Boards shall be established at Calcutta, Madras and Bombay...

(B) Section 27. The several persons who were, immediately before the appointed day, respectively the Directors of the Presidency Banks, shall constitute the first Local Board of the Banks at Calcutta, Madras and Bombay respectively, and the persons who were then President, Vice-President, and Secretary respectively, of the said Banks, shall fill the same office in the respective Local Boards until they vacate office in accordance with the provisions of the Act.

(C) Regulation 43, clause (1)—At the first general local meeting after the commencement of this Act, and at the annual general local meeting thereafter, the two members of the Local Board who have been longest in office as members thereof shall go out of office. The vacancies shall be filled by *election* at a general or special local meeting.

(D) Regulation 44, clause (1). At the first meeting of the Local Board in every year, it shall choose a President and Vice-President from amongst its own members, and, whenever the office of President or Vice-President becomes vacant, the Local Board shall, at its next meeting, choose a successor for the remainder of the current year: Provided that no person shall be chosen to be President or Vice-President twice in succession.

It is nevertheless an important step in the direction of establishing a real State Central Bank in India, and is a material advance on the state of affairs which existed prior to amalgamation. We may therefore notice a few details of this amalgamation scheme.

(A) *Capital.* The capital of the new Imperial Bank has been provided partly by amalgamating the capital of the three Presidency Banks and partly by increasing its authorized capital from Rs. 375 lakhs to Rs. 1,125 lakhs, of which Rs. 562½ lakhs or one-half was paid at the outset.

(B) *Constitution.* Its constitution, as already stated, provides for (1) a Central Board, and (2) three Local Boards in the three Presidency towns. The Central Board is to deal with matters of general policy, such as the transfer of funds from one part of the country to another, fixation of the bank rate (which in future is to be uniform for the whole of India), and the publication of the weekly statement. Its composition is intended to secure representation of all important interests concerned, including Government, the Local Boards, the shareholders, and the general public. It has a *small* Managing Committee of its own, to which it has authority to delegate almost all its functions. If any Local Board is dissatisfied with the orders of the Managing Committee, it has a right to insist on a meeting of the Central Board. The Local Boards elected by the shareholders on the local register in the three Presidency towns are intended to safeguard local interests and are possessed of large powers of autonomy. A general meeting of the shareholders of the Imperial Bank is to be held on the first Monday of August every year, at such time and at such local Head office of the Bank, as shall from time to time be prescribed by the Central Board, at which meeting the Central Board is to submit to the shareholders a statement of the affairs of the Bank made up to the preceding thirtieth day of June. The decisions at any of the meetings of the shareholders are binding on the Bank so far as they are consistent with the provisions of the new Act.

(C) *Business.* Its business will generally follow the lines of that of the old Presidency Banks, but certain restrictions which proved inconvenient in practice have now been removed. For instance, the new Act permits for the first time the

constitution of a London office and the borrowing of money in England for the purpose of the Bank's business upon the security of the assets of the bank. It is now the sole banker of Government, the Reserve Treasuries having been abolished. Government no longer undertakes to transfer money for the general public between any two places; the Imperial Bank is to do this remittance work at rates not exceeding those approved by the Controller of Currency. It will retain in its hands the administration of the public debt work; and arrange, in connection with the encashment of notes, to supply the public as far as possible with the form of currency they require. It has now a London office; but this is not to compete with the exchange banks in ordinary exchange business. It will conduct business only on behalf of its own constituents and rediscount bills for other banks.

(D) *New branches.* A statutory obligation has been imposed on the Bank to open, within five years from the commencement of the Act, not less than 100 new branches, of which at least one-fourth are to be established at such places as the Government of India may direct.

6. The following table, taken from the Commercial Intelligence Department, India, gives the capital, reserves, deposits, and cash balances of the three Presidency Banks regarded as one bank up to the year 1920, and of the Imperial Bank of India from 1921 :—

31st December	Capital	Reserve and Rest	Government or public Deposits	Private Deposits	Proportions of Government deposits (column 3) To		Cash balances
					T. cap & deposits (cl. 1 to 4)	Private deposits (cl. 4)	
	1	2	3	4	5	6	7
	Rs. 1,000	Rs. 1,000	Rs. 1,000	Rs. 1,000	%	%	Rs. 1,000
1913 (pre-war year)	3,75,00	3,73,07	5,88,66	36,48,50	11.8	16.1	15,37,75
1914	3,75,00	3,89,17	5,61,52	40,04,08	10.5	14.1	20,83,92

31st December	Capital	Reserve and Res.	Govern- ment or public Depo- sits	Private Deposits	Proportions of Govern- ment deposits (column 3) To		Cash balances
					T. cap & deposits (cl. 1 to 4)	Private deposits (cl. 4)	
5	6	7					
	Rs. 1,000	Rs. 1,000	Rs. 1,000	Rs. 1,000	%	%	Rs. 1,000
1915	3,75,00	3,72,59	4,88,67	38,61,19	9.6	12.7	14,65,24
1916	3,75,00	3,60,99	5,20,58	44,70,87	9.6	11.6	17,27,25
1917	3,75,00	3,67,52	7,71,28	67,71,74	9.3	11.4	33,77,31
1918	3,75,00	3,44,58	8,64,28	50,97,75	12.8	16.9	17,07,62
1919	3,75,00	3,57,81	7,72,24	68,21,37	9.3	11.3	23,62,93
1920	3,75,00	3,77,79	9,02,63	78,01,90	9.5	11.6	26,03,34
1921	5,62,24	4,14,54	6,80,01	65,77,99	8.3	10.3	13,60,23
1922	5,62,50	4,33,07	14,15,73	57,00,57	17.5	24.8	15,07,47
1923	5,62,50	4,55,21	8,56,14	74,19,51	9.2	11.5	15,01,34

PART II

CHAPTER X

CLOSURE OF THE MINTS, 1893

1. We have in the preceding chapters referred several times to the principles underlying the changes effected in 1893. It is now time to examine critically the reasons which led Government to propose these far-reaching changes, and the grounds on which they condemned the free and automatic silver standard which prevailed in India before 1893.

In chapter iv we have already described the wide fluctuations in the price of silver in the period 1872-1892, and explained the effect of the variations in the price of silver on exchange between silver and gold-using countries. The price of silver began its downward course in the period 1872-5, when it fell from 60 $\frac{5}{8}$ *d.* to 56 $\frac{1}{8}$ *d.* per oz. During the same period the rupee-sterling exchange, which had stood almost uniformly at a trifle below 2*s.* during 1863-74, gradually dropped down to 1*s.* 9·628*d.* (1875-6). Since then, with every fall in the price of silver, there was a corresponding fall in India's exchange¹ with gold standard countries. Exchange with other silver standard countries was, however, free from this disturbing cause. It was comparatively steady, its normal range being determined by the 'silver points', the counterparts of the 'gold points' in exchange between gold standard countries.

To many engaged in the trade between India and the United Kingdom this state of affairs appeared almost intolerable. They complained that trade with gold standard countries was seriously harrassed by these fluctuations in exchange, and that all legitimate trade was replaced by mere speculation and gambling. They argued on *a priori* grounds, that the tendency of a falling exchange was to depress the import trade, especially in cotton goods, inasmuch as it increased the price in rupees of goods imported from the United Kingdom and other gold standard countries, and to confer an unfair advantage on the exporter from India, inasmuch as it enabled him to receive a higher

¹ See table on page 33.

silver price in respect of the same gold price, whilst wages and other factors of production in India remained much the same as before. They contended that the falling exchange imposed a special disadvantage on India's trade with European countries, and diverted it to silver standard countries. These supposed evil effects of the fall in exchange on Indian commerce, especially her import trade, constituted the first charge in the indictment against the silver standard.

The second group of people who complained against the silver standard consisted of English officials, employed mostly in Government departments, who received their salaries in rupees, but had constantly to remit a substantial part of their earnings to England either as savings or as contributions to their families. The decline in the sterling value of the rupee appeared to inflict on them an unmerited loss: they might have saved the same number of *rupees* as before, but their families in England received fewer *sovereigns* in exchange for them. They felt that they had a legitimate cause of complaint against Government, when they found that several European commercial houses had sanctioned a special allowance to their European employees to compensate them for the loss which they suffered owing to the fall in exchange.

But by far the most important consideration with those who advocated a departure from the silver standard, was the financial burden which the falling rate of exchange was said to impose on the Indian Government. Every year India has to make substantial payments in England, known as Home charges, for such items as interest and annuities on the debt, salaries, pensions and leave-of-absence allowances of foreign employees in India's service, purchases of stores in England, and other expenses incurred by the Secretary of State on behalf of the Indian Government. As all these payments were on a gold basis, the fall in exchange increased the amount of *rupees* to be laid aside by the Indian Government in order to remit the Home charges in sterling. The element of uncertainty which this factor introduced in the Indian Budget was forcibly pointed out by Sir David Barbour in the following passage in one of his published statements: 'Our financial position for the coming year is at the mercy of exchange, and of those who have it in their power to affect in any way the price of silver. If we budget for the

present deficit of Rs. 1,595,100, and exchange rises one penny, we shall have a surplus; if it falls a penny, we shall have a deficit of more than three crores; if we impose taxation to the extent of one and a half crore of rupees, a turn of the wheel may require us to impose fresh taxation of not less magnitude; another turn, and we may find that no taxation at all was required.' In other words, the Indian budget was said to be 'a gamble in exchange'. The continuous fall in exchange was alleged to involve Government in a heavy loss, which had to be made up either by (a) retrenchment, or (b) by fresh taxation. Neither of these two courses appeared feasible to Government. They considered it impossible to meet by retrenchment the 'great and growing deficit caused by falling exchange', and they found it difficult to lay their hands on any satisfactory method of increasing the revenue. They fought shy of import duties on cotton goods or an export duty on cotton, because of the storm of protest it was likely to raise in Lancashire. They felt that they would be committing a serious political blunder if they were to increase the burden of income-tax or salt tax, as these taxes were already unpopular in India. There remained only Land Revenue to fall back upon, but a part of the country was under permanent settlement and the rest settled for long periods of thirty years. Moreover, in the larger part of the country the thirty years' settlement had been made only recently. The obstacles to the increase of revenue thus seemed almost insuperable; and Government came to the conclusion that the only solution of these difficulties lay in changing the standard.

2. Let us examine each of these complaints critically. There is no doubt that theory supported the view that, *other things remaining the same*, a depreciating currency or a falling exchange tended to stimulate exports and discourage imports. But at the same time it showed (a) that the advantage to the exporter was largely at the expense of the other classes of the community, and (b) that it could be only temporary. As pointed out by Professor Marshall in his evidence before the Fowler Committee, the common opinion, that a depreciating exchange was for the benefit of an export trade, rested upon the natural habit of regarding the interests of the *entrepreneur* as co-extensive with those of the trade. What really happened when a currency was depreciated, was that a person who was under obligations to make

certain currency payments (those obligations being in some cases fixed by definite contracts, in particular when he had already borrowed money at a definite rate of interest, but in other cases governed by custom), was allowed, through the change in the value of the currency, to discharge those obligations at less cost to himself and less benefit to those who were engaged with him in trade. There was no doubt that a fall in the value of the currency was a bounty; but it was a bounty *not to the export trade* but to *one class* in the export trade at the expense of the other classes engaged in it.

It is easy to see how long this bounty could last. The depreciating rupee was advantageous to exporters only so long as the cost of production and prices in India did not rise in terms of silver. When that happened, the bounty would disappear. In other words, there was a race between the *specific depreciation* of the rupee in terms of sterling, and its *general depreciation* in terms of commodities and services. Exports would be stimulated only so long as the specific depreciation was greater than the general depreciation.¹

Turning now to the available statistics of India's foreign trade during the period of falling exchange, we find still less support for the fears of the alarmists in England. Imports from gold standard countries did not show even a temporary decline; on the contrary they showed appreciable increase. The proportionate increase of exports from England to India was greater than from India to England; and the increase had been steady. English trade with India had increased, both absolutely, and relatively to her trade with other countries, as will be seen from the following figures placed before the gold and silver commission by Mr. Waterfield:—

Years	Figures representing the total trade between India and the United Kingdom		Percentage of trade with India to the whole trade of the United Kingdom
	Imports into India	Exports from India	
1874-5	100	100	8·5
1875-6	96	101	8·5
1876-7	110	105	8·5

¹ Minutes of Evidence, Fowler Committee's P. 71595296.

Years	Figures representing the total trade between India and the United Kingdom		Percentage of trade with India to the whole trade of the United Kingdom
	Imports into India	Exports from India	
1877-8	132	110	8.9
1878-9	93	101	8.5
1879-80	108	99	7.8
1880-1	132	111	8.9
1881-2	127	125	9.2
1882-3	135	127	9.8
1883-4	145	132	9.9
1884-5	147	121	9.7
1885-6	146	124	9.8
1886-7	154	125	10.5

In fact, circumstances were on the whole exceptionally favourable to imports from the United Kingdom. During the period 1873-93, the gold prices of cotton manufactures declined on the average 34 per cent, the gold price of sugar fell 38 per cent, that of iron bar 60 per cent and of petroleum 74 per cent; while the maximum fall in exchange was only 34 per cent. In these circumstances there could be no advance in rupee prices of imported goods.

Nor did statistics support the allegation that the falling exchange stimulated exports and discouraged imports. The available figures led the Herschell Committee to the following conclusion on this point: 'Although one may be inclined, regarding the matter theoretically, to accept the proposition that the suggested stimulus would be the result of a falling exchange, an examination of the statistics of export produce does not appear to afford any substantial foundation for the view that in practice this stimulus, assuming it to have existed, has had any prevailing effect on the course of trade; on the contrary, the progress of the export trade has been less with a rapidly falling, than with a steady,

exchange. For example, from 1871-2 to 1876-7, while the gold value of the rupee fell constantly from 23·126*d.* to 20·508*d.*, or about 11½ per cent, the exports of merchandise were actually less in the later years than in the former, although in 1876-7 their rupee value exceeded by about 10 per cent that of the exports of either 1870-1 or 1872-3. From 1878-9 to 1884-5 exchange was fairly steady, the average rates varying between 19·061*d.* and 19·308*d.* per rupee or about 3½ per cent; and during these six years the exports rose by no less than 36½ per cent. Again, between 1884-5 and 1888-9 the fall of the rupee was very rapid, from 19·308*d.* to 16·379*d.* or over 15 per cent and the exports increased during those four years by 16½ per cent; but in the single year 1889-90, when there was a slight improvement in the exchange, the exports increased by more than 6½ per cent. It is said, too, that whilst a falling exchange tends to stimulate exports, there is a corresponding tendency to check imports. Here, again, *statistics* do not seem to show that diminished imports have been coincident with a lower exchange. Taking the same periods as before, from 1871-2 to 1876-7, when exchange fell 11½ per cent, imports of merchandise to India increased by 17 per cent; from 1878-9 to 1884-5, when exchange was steady, the increase of imports exceeded 47 per cent; between 1884-5 and 1888-9, when the rupee fell about 15 per cent, the imports were augmented by nearly 25 per cent; while in 1889-90, when exchange rose slightly, the imports were rather less than in the previous year. Upon the whole, we cannot see any evidence that the effect of a falling exchange on the country at large, in influencing either exports or imports, has over a series of years been very considerable. Some trains of *a priori* reasoning would seem to lead to the same conclusions, and also to the further conclusion that, even if a fall in the gold value of the rupee does stimulate exports, the result is not necessarily to the benefit of India as a whole, though it may temporarily benefit the employer at the expense of the wage-earner, because wages rise more slowly than prices.

On the whole the foreign trade of India was progressing quite satisfactorily under the silver standard. Its value had more than doubled since 1874-5, when the fluctuations of exchange began. It was 800 lakhs in 1873-4; it had increased

to 1,700 lakhs in 1890-1. It was Rs. 5·4 per head of the population in 1880 ; it went up to Rs. 6·8 per head in 1890.¹

No doubt the frequent fluctuations of exchange introduced an element of uncertainty in commercial bargains ; but this was by no means an insuperable difficulty. As was explained by several witnesses before the Gold and Silver Commission, ' If a particular fluctuation in the exchange involves a loss on an export transaction from this country (United Kingdom) to the East, it must simultaneously give rise to a corresponding gain on an export transaction in the opposite direction. To the merchant engaged in both the export and import trade, any loss will therefore be balanced by a gain ; while as regards others, it is the business of dealers in exchange to balance those losses and gains, and their charges for their services will, by competition among themselves, be reduced to the lowest possible rate, the burden of which will practically be inappreciable.' As a matter of fact, this element of risk was greatly eliminated by various devices, such as ' the making of forward contracts with the Exchange Banks for the purchase or sale of exchange at rates, fixed months in advance, and " hedging " through the forward purchase or sale of silver on the London market, so that the loss on exchange would be compensated by a profit on the silver transaction and *vice versa*.'

But even if the foreign trade of the country suffered some inconvenience, that was hardly an adequate reason for changing a currency system that was otherwise suited to the needs of the country. After all, the external trade of India with gold-standard countries was only 5 per cent of its total (external and internal) trade. In deciding upon the monetary standard best suited to India, the internal trade of the country had a far greater claim upon the attention of the authorities. An overwhelming majority of the witnesses before the Herschell Committee agreed that the silver standard was the most suitable for the internal trade of India ; and in the face of this evidence, to force a change of standard in India because of its 70 to 80 per cent *external* trade was hardly a justifiable decision.

Even from the narrow point of view of India's *foreign trade*, a debtor country like India had reason to attach great importance

¹ See the evidence of Sir Frank Forbes.

to its trade with silver-using countries, which was likely to be adversely affected, at least temporarily, by any rise in exchange. For India then depended for its *favourable* balance of trade more upon its trade with silver-using countries than upon that with gold standard countries, as the following tables will show :—

Table I.—Trade of India with gold and silver countries respectively in 1890-91 (omitting Government stores)

Gold countries			Merchandise. Net exports (i.e. exports- imports)	Final balance. Merchandise and Treasure, Net exports
			Rs.	Rs.
United Kingdom	...	...	— 19,346,680	-- 29,847,893
Continent of Europe except Russia	Austria and	...	18,177,539	17,884,168
Asia : Turkey and Java	...	...	185,783	— 45,149
Africa : Cape, Natal, St. Helena and	...	...	4,716,602	4,510,690
Egypt	...	...	2,651,848	2,646,348
America : Canada, United States and	...	...	977,169	— 639,511
West Indies	...	...
Australasia	...	...
Total			7,362,261	— 5,491,338
Silver countries				
Europe : Austria and Russia	...	...	2,254,113	1,277,386
Asia, except Turkey and Java	...	...	20,276,541	14,269,527
America : South	...	...	729,112	729,112
The rest (including East Coast of Africa, Mauritius and Madagascar)	...	...	478,795	504,827
Total			23,738,561	16,780,852

Table II.—Trade of India with gold and silver countries in 1891-2 (omitting Government stores)

Gold countries	...	...	19,398,360	11,485,093
Silver countries	...	...	22,050,193	18,527,484
Total			41,448,553	30,012,577

3. The second ground of complaint likewise appears on close examination to have no substance in it. The official in India had suffered no appreciable loss for which he deserved any compensation. The loss in remitting money to England was to a large extent covered by the gain from the *fall* in English prices during this period. If exchange had not fallen, he would no doubt have gained by this fall in prices; but he had no moral claim to this undeserved gain as it had not entered into his calculations at the time he joined service in India.

Besides this, allowance had to be made for the fact that the salaries of these officials were higher than they need have been. As Mr. Adams pointed out to the Herschell Committee 'all salaries of servants in India were fixed a very long time ago, when salaries for services requiring an equal standard of ability and character were at a much higher level' than the market rate prevailing at the time of the evidence.

Taking the most generous view of the matter, the English official in India was entitled to compensation only to the extent to which it was reasonable that he should remit money to England, say one-third of his salary. Even this concession was justifiable only in the case of people who had entered the service under existing contracts. As for future recruits, Government should have fixed their salaries, pensions, etc., in silver rather than force on India a change in her monetary standard. At any rate, 'to tamper with the monetary standard of a vast population for the sake of what was relatively a small, and mainly a foreign, interest savoured of setting another person's house on fire to roast one's sucking-pig' and was 'something like the betrayal of a national trust, all the more glaring in that Great Britain did not in its discharge take the people themselves into council.'¹

4. The last was undoubtedly the most weighty argument. The fall in exchange made the task of framing a satisfactory *budget* a difficult one; and at times threatened to involve Government in considerable embarrassment. But the extent of loss from this source was greatly exaggerated in the usual official complaints against the silver standard. The official figures for loans raised by India in England were calculated on the basis

¹ From the memorandum of R. B. Chapman, C. S. I., Secretary to the Government of India in the Department of Finance and Commerce from 1869-81.

of 2s. exchange, whereas a great many of them had been raised at rates varying from 1s. 11d. to 1s. 9d. down to 1s. 7d.¹ Government was shown to have incurred a loss on the amount spent in the purchase of stores in England on account of the fall in exchange, whereas, owing to the greater fall in gold prices, Government in reality had gained and not lost in respect of this item.²

Nor was the situation so desperate as to call for so drastic a remedy. The financial history of the period of falling exchange lent no support to the alarmist view Government seemed to take. The following table taken from the Appendices to the Fowler Committee's report shows the net financial result for each year from 1872-73 to 1893-94.

Price of silver ; Rate of exchange ; surplus or deficit in account of Government of India, 1872-73 to 1893-94.

Years	Average price of silver in London per oz	Average rate per rupee at which bills & T. T. on India were sold by the Secretary of State	Surplus or deficit (-) of the year	Remarks
	d.	d.	Rs.	
1872-73	60 $\frac{5}{16}$	22.754	17,65,672	Commencement of decline in price of silver.
1873-74	59 $\frac{1}{4}$	22.351	-18,07,668	Demonetization of silver by the German Government.
1874-75	58 $\frac{6}{8}$	22.156	3,19,197	} Famine in India.
1875-76	56 $\frac{3}{4}$	21.628	15,89,255	
1876-77	52 $\frac{3}{4}$	20.508	-25,84,176	
1877-78	54 $\frac{1}{2}$	20.791	-42,62,040	
1878-79	52 $\frac{1}{2}$	19.794	21,34,098	
1879-80	51 $\frac{1}{2}$	19.961	-12,27,893	Suspension of sales by the German Government.
1880-81	52 $\frac{1}{4}$	19.956	-36,31,394	Diminution in production of Californian mines.
1881-82	51 $\frac{1}{4}$	19.895	35,95,451	Monetary conference in Paris.
1882-83	51 $\frac{1}{2}$	19.525	6,74,837	
1883-84	50 $\frac{3}{4}$	19.536	18,79,477	
1884-85	50 $\frac{3}{4}$	19.308	-3,86,446	

¹ See evidence of Sir Frank Forbes.

² See Prof. Marshall's evidence before the Gold and Silver Commissions (2-10-144).

Year	Average price of silver in London per oz.	Average rate per rupee at which bills & T. T. on India were sold by the Secretary of State	Surplus or deficit (—) of the year	Remarks
	d.	d.	Rs.	
1885-86	48 $\frac{5}{8}$	18·254	—28,01,726	Suspension of coinage of the Bland dollar recommended by the President of the United States.
1886-87	45 $\frac{3}{8}$	17·441	1,78,427	} Great depression in trade.
1887-88	44 $\frac{5}{8}$	16·898	—20,28,832	
1888-89	42 $\frac{5}{8}$	16·379	37,018	
1889-90	42 $\frac{1}{8}$	16·566	26,12,033	Purchases of silver by the U. S. Treasury raised to 51,000,000 ounces a year.
1890-91	47 $\frac{1}{8}$	18·089	36,88,171	
1891-92	45 $\frac{1}{8}$	16·733	4,67,535	Monetary conference in Brussels.
1892-93	39 $\frac{1}{8}$	14·985	—8,33,412	
1893-94	35 $\frac{5}{8}$	14·547	—15,46,998	Indian mints closed to free coinage. Repeal of the purchasing clauses of Sherman Act in the U. S. A.

It will be seen from the above, that in the decade 1883-84 to 1892-93, though there had been years of deficit and years of surplus, there had been on the whole, on a balance of ten years, a *surplus*; and this in spite of the fact that the expenditure chargeable to revenue had been swollen by various non-recurring contingencies, such as the cost of annexation and pacification of Upper Burma, the expenditure on fortifications of the North-West Frontier and coast defences, equipment of the army with new rifles, and numerous punitive expeditions. During the same decade, Government had paid off, out of the *revenue*, a considerable sum towards the reduction of the permanent debt of India. Even if we take the *twenty* years ending in 1892-93 we get a net deficit of less than Rs. 24,00,000, by no means an unsatisfactory record for a country like India.¹ In fact so competent a financier as Sir Robert Giffen remarked: 'So far as my judgment goes, Indian finance on the whole has been exceedingly prosperous, . . . there are few countries in the world that can show such a record for twenty years, (or

¹ *Vide* evidence of Messrs. Adams and Ralli before Herschell Committee.

which) have gone through these twenty years with so small a deficit in the aggregate. I think also, if the thing were looked into, it would be found that the permanent burden of India had not been increased in any substantial way even by borrowing for new works, but that considerable conversions of the debt had been effected.'

Even one of the official witnesses, Mr. Robert Hardie, Member of the India Council, admitted in his evidence before the Herschell Committee that 'as a matter of fact the difficulties *so far* have not been very serious.'¹ His case was that the Government were 'apprehensive of greater difficulties in the *future* than had occurred in the past.'¹ It was thus the *prospective* rather than the actual difficulties which made the Government so nervous. But even if these fears had materialized, was it not possible to meet the situation by retrenchment? Was it not within the range of practical politics to apply the pruning-knife, if not to civil expenditure, at least to some portion of the military expenditure, or the expenditure on public works out of the revenue, which no one dreamt of so financing in England? This plain issue was cleverly evaded by the Herschell Committee, as the following extract from their report will show: 'There is . . . another way in which the deficiency may be met, namely, by reduction of expenditure. We are quite alive to the importance of this resource, and to the expediency of urging economy in every practical way, more especially as there is no pressure brought to bear on the Government of India like that to which the Chancellor of the Exchequer in his country is subjected by the representatives of the taxpayers. But, difficult as it is for us to form an opinion on the possibility of raising additional revenue, it is still more difficult to estimate the possibility of reducing expenditure. In order to do so, it would be necessary to enter upon an examination of the policy and action of the Government of India, both in military and civil matters, *a task which is beyond our province*.¹ Experience, however, shows, as regards military expenditure, that it is at all times difficult to resist its growth, and that occasionally the circumstances which call for it are beyond the control of any Government; while, as regards civil expenditure, an advancing

¹ The italics are ours.

civilization brings with it constantly increasing demands for Government action and enterprise, demands which are not the less urgent when, as is the case in India, they must originate with the Government, rather than, as in Europe, with the people. Although, therefore, we feel strongly the necessity for the utmost care in restricting expenditure, we are certainly *not in a position* to conclude that any economies are possible which would enable the Indian Government to meet successfully the great and growing deficit caused by falling exchange.¹

Nor was it easy to accept the official view that Government could not increase taxation or that they could not find the means of meeting their gold obligations. As Sir Robert Giffen pointed out, the community of India—the *Government and the people together*—were not really affected in any way by changes in the value of their own money with reference to any foreign money in which their obligations had to be paid. The gold debt of the country was *really paid* by the remittance of *surplus produce* from India, the magnitude of which depended upon the yield of harvests, and on the value for which the produce could be sold in the money obtained outside India. If, owing to the appreciation of gold, India was obliged to send a larger amount of produce than formerly to meet this debt, the case was one in which there *must be increased taxation in some form or other*. Either there must be new taxes or the old taxes must be made to command *more produce* by an artificial *enhancement of the value of the rupee*; in either case the final result was the same, there was an increase of taxation of the people of India of an entirely unavoidable kind. If, on the other hand, the case was one in which the *same* produce had to be sent from India as before, but the Indian Government was not able to command the same produce in consequence of the *depreciation* of its money, then what the Indian Government lost at the moment, through its revenue being insufficient to obtain command of produce required to meet its gold debt, clearly amounted to a *remission* of taxation of equal amount to the people of India. The problem in that case was, *not* how to *increase* taxation as compared with what it was before, but how to make the taxation *equivalent* to what it was

¹ The italics are ours.

before. For that purpose new taxes would be necessary ; but that would not be new taxation on the community generally ; the burden of taxation after they were imposed would not be any greater than it was before the depreciation of the rupee had taken place. It was therefore difficult to accept the statement of responsible officials that new taxes could not be imposed.

Coming to particular items, it was easy to show that railway rates, which were charges for services done in the way of business, ought to have been capable of yielding a much larger revenue if there was a real depreciation of the rupee. Then there were the import duties, which could easily have been trebled—for the Indian Customs tariff was then one of the lowest amongst countries in a similar economic position—if only the Government of India had had the courage of their convictions. It is doubtful whether the British House of Commons would have prevented the Indian Government from raising their revenue in this way, and taken the serious responsibility of compelling them to alter the monetary standard instead. But, even if these fears had materialized, it was the clear duty of the Government of India to make a bold stand for a principle. The closing of the mints itself was not, according to the *theory on which Government advocated it*, a *real escape* from further taxation of the people. It was more or less a political manœuvre calculated to hide the real effects of the monetary change. Had the sterling value of the rupee risen *through a rise in its purchasing power* in terms of commodities, the advantage to Government in their annual remittance to England would have been *paid for by the producer*, who would have been obliged to accept fewer rupees for the produce he sold. As Messrs. Campbell and John Muir forcibly pointed out in their dissenting note to the report of the Fowler Committee, ‘to deny that arbitrary enhancement of the currency is a tax, and to argue that the producer is no worse off in the long run, that wages and other charges adjust themselves to its altered value, is to maintain the dangerous principle that Government may lighten its liabilities without injury to anybody by a step of this kind.’ As a matter of fact, however, the rupee did not rise in purchasing power, except temporarily ; and these consequences did not ensue. Nevertheless, the closure of the mints inflicted a serious loss on the poor

Indian ryot. It produced a heavy fall in the value of silver as a commodity ; it thus depreciated the value of the ryot's silver ornaments—the only form of savings known to him, the only provision he had made against famine times. Formerly, under the open mints, he could easily have converted his silver ornaments into rupees ; he could no longer do so without incurring heavy loss. Formerly in times of scarcity and famine, a considerable quantity of silver ornaments found its way to the mints. ' During the period of the great famine in 1877 and the following years, for example, large quantities of such ornaments were minted. In three years, no less than Rs. 45,00,000 was thus turned into money.'¹ These facts point unmistakably to the conclusion that even this, the most weighty argument against the silver standard, was hardly strong enough to justify the monetary revolution of 1893.

5. It is sometimes the practice with partisans of the gold standard to suggest, by a glowing description of the progress of India in the period following 1893, that the silver standard was an obstacle to progress. How little justification there is for this view will be clear from the following summary of a paper read by Sir W. Hunter at the Society of Arts on the 16th February 1892 :—²

' Between 1881 and 1891 the whole number of the army had been raised from 1,70,000 to 2,20,000, and the number of British soldiers in it from 60,000 to 71,000, or, including reserves, volunteers, etc., to very much more. Many large and costly defensive works had been constructed both on the North-West Frontier, and on the coasts. In recent years almost all public buildings have been reconstructed on a large scale.

' Railways, both military and commercial, have been very greatly extended. Notwithstanding these extraordinary expenses, there were, during the twenty-five years which followed 1862, fourteen years of surplus, and eleven years of deficit yielding a net surplus of Rs. 40,00,000. In 1889 the public debt of India, exclusive of capital invested in railways, showed a reduction, since the Mutiny period, of Rs. 2,60,00,000. The rate at which India can borrow has been reduced from four or five per

¹ Herschell Committee.

² Quoted in paras. 2 and 3 of T. H. Farrer and R. E. Welby's Minute of Dissent from the Majority Report (Herschell Committee).

cent to a little over 3 per cent. The revenue of India, exclusive of Railways and Municipal funds, has grown between 1856-57 and 1886-87 from Rs. 3,33,78,000 to Rs. 6,28,59,000, and in 1891 it had increased to Rs. 6,40,00,000, or including Railways and Irrigation receipts to Rs. 8,57,50,000, and this increase is due to the growth of old revenue rather than to new taxation. Further, whilst the rent or land tax paid by the people has increased by one-third, the produce of their fields has more than doubled, in consequence partly of higher prices and partly of increase in cultivation. Further, in 1891 there were nearly 18,000 miles of railway open, carrying 121,000,000 passengers and 26,000,000 tons of goods, and adding a benefit to the people of India, calculated as far back as 1886 at Rs. 6,00,00,000. Further, the Indian exports and imports at sea, which in 1858 were about Rs. 4,00,00,000, amounted in 1891 to about Rs. 20,00,00,000, and the produce thus exported has increased in quality and variety no less than in amount.'

6. But was the silver standard to blame in any way for the continuous fall in exchange with gold standard countries? Had *gold* become more valuable in itself, or silver less valuable in itself, or if both movements had happened, which had been relatively greater? This preliminary issue, though raised by Mr. Leonard Courtney in his dissenting minute, was not examined by the Herschell Committee. An examination of the broad facts of the situation, however, leaves no doubt in the mind that the fluctuations in exchange-rates were due, primarily, to an appreciation in the value of gold, and not to a depreciation in the value of silver.

In all the countries that had adopted the gold standard, a marked decline of prices had set in during this period, partly because of the enhanced demand of gold as currency, and partly because of a decline in the world's production of gold. Prices in England, for instance, fell by about 45 per cent between 1873 and 1893; in other words, there was a rise in the value of gold, expressed in terms of its purchasing power, not over one commodity like silver, but over a group of forty-five commodities. And this rise was continuous and rapid. Taking the year 1873 as the base for comparison, and expressing the purchasing power of gold over forty-five commodities in that year by 100, the corresponding figures for the

years 1877, 1878, 1883, 1885, and 1887, as calculated by Professor Kemmerer, an American economist, are 128, 134, 135, 154 and 163, respectively.

It is interesting to note that prices fluctuated far more in England under the gold standard than in Shanghai under the silver standard, and that the general purchasing power of *gold* was more unstable than that of silver in England, India or Shanghai. Judged by the test of these facts, it was gold and not silver that lacked *stability*. And it was mainly because of this instability in the value of gold that there was a constant fall in the rupee-sterling exchange. No doubt, there was some decline in the value of silver also, owing to various causes, such as the demonetization of silver in most of the European countries and the continuous increase in the world's production of silver. But, taking the period as a whole, the purchasing power of the rupee varied much less widely than that of the pound. According to the calculations of Professor Kemmerer, 'For the pound, the extreme range of the Index numbers was sixty-three points (100-163); while for the rupee it was but thirty-one points (103-72). Ignoring the worst famine year, i.e., 1878, the range for the rupee was but 27 points (103-76).'¹

If then, stability of value in terms of general purchasing power and not in terms of a single commodity, however important, be an essential attribute of a good standard of value, the Indian currency system during the period 1872-93 satisfied that test better than the gold standard of European countries. At any rate, a standard which showed this stability did not deserve to be dismissed in the summary fashion in which the Herschell Committee condemned it.

7. There remains one other point to consider in connection with the closing of the mints. The theory on which the proposal to close the mints was based was explained, twenty years later, by Sir David Barbour, the real author of the monetary changes, as follows: 'I was firmly convinced of the soundness of the *quantity theory* of money and knew that, if the unlimited coinage of silver was stopped, it was quite possible to reduce the amount of the rupee circulation to such an extent as

¹ Kemmerer's *Modern Currency Reforms*, p. 21.

to bring the Indian exchange to a par with gold at a rate of exchange which could be permanently maintained. How great the necessary amount of reduction might be I could not tell.' The plan was variously called by its advocates 'Starving the currency', 'Rarefaction of the currency', 'Creation of scarcity value', and 'Relative contraction of the currency'.

Do the facts of the period 1893-98 show that the rise in exchange actually brought about was due to this relative contraction of currency and the consequent increase in the purchasing power of the rupee? The relevant facts to note in this connection are :—

(1) The *rise* in the value of the rupee as measured by its purchasing power over commodities immediately after the closing of the mints, the index number of prices in India falling from 129 in 1893 to 120 in 1895 (*vide*, p. 148, chapter xii).

(2) *The fall* in the average exchange value of the rupee from 14.546 *d.* in 1893 to 13.638 *d.* in 1895.

(3) A heavy *depreciation* in the purchasing power of the rupee during the years 1896 and 1897, its index number of prices being 131 in 1896 and 153 in 1897.

(4) The rise in rupee-sterling exchange from 13.638 *d.* in 1895 to 14.450 *d.* in 1896 and 15.406 *d.* in 1897.

These facts lend no support to the claim that the closure of the mints raised exchange-rates through its effect on the general purchasing power of the rupee. There is, moreover, reason to believe that, in spite of the closing of the mint, there was very little of 'relative contraction of the currency'. Apart from a decline in the amount of goods sold because of famine in 1896-97, and a small expansion of circulating bank credit during this period, the monetary circulation was actually increased in three different ways. Firstly, under an Act of December 17, 1896, 20 millions of rupees were released from the Paper Currency Reserve and put into circulation by the end of March 1897. Secondly, Government spent large sums in relief work out of their cash balances, with the result that the treasury balances were reduced from Rs. 185.3 millions in 1894-95 to Rs. 99.7 millions in 1896-97. Lastly, large amounts of rupees were withdrawn from hoards and put into circulation. It is plain that the rise in exchange in these circumstances must

have been due to causes *other* than 'rarefaction of currency'—a fact practically admitted by the Fowler Committee, as the following extract from its report will show: 'In the first place, we desire to point out that it has not been proved that the rise in the value of the rupee since 1894-95 is due solely to relative contraction of the Indian currency; and it may be that it is not mainly to this cause. It is not certain that there has been any contraction of the Indian Currency that has materially affected the exchange, though it may not unreasonably be inferred that there must have been some contraction, and that such contraction has had some influence on the exchange value of the rupee. On the other hand, there are causes other than contraction of the currency, which affect the value of the rupee and the exchange with London. *Large borrowings* in London on account of India, *reduction of the drawings* of the Secretary of State, an *increase in the exports from India unaccompanied by an equivalent increase in imports*, as well as a *general rise in gold prices*, would all affect the rate of exchange with India, though it is quite impossible to estimate the relative importance of these factors among themselves, or the amount of their influence on exchange as compared with the effect of a contraction of the currency, or to state the price degree of influence which any or all of them have had on any particular alteration in the exchange. Nor, on the other hand, is it certain that the unusually low rate of exchange that prevailed in 1894-95 was due solely to a relative redundancy of the Indian Currency. The closing of the Indian mints necessarily brought into play many disturbing influences, which may have affected the exchange in 1894-95.

'Since the mints were closed there have also been *large borrowings* on Indian account, and there have been, in some years, *large reductions* below the normal amount in the *public remittances* from India, while fluctuations have been experienced in the foreign trade of India, due to famine and plague as well as the other cause. All these causes must at different times have affected the exchange either favourably or unfavourably.

'Another influence which must have had a favourable effect on the Indian exchange is the *reduction in the imports of silver* due to the closing of the mints. The average yearly net import in the three years preceding the closing of the mints, was

43,133,678 oz. of the value of Rs. 1,20,20,296; and for the three years ending 1898-99, the average net import was 31,126,376 oz. of the value of Rs. 61,03,431.

‘In the face of these facts we have just stated, we are unable to accept, without qualification, the opinion that the rise in the value of the rupee since 1894-95 has been due wholly, or mainly, to relative contraction of the Indian currency. We are not prepared to say that the contraction of the Indian currency has not been an important factor in the rise in the Indian exchange; but, so long as the facts of the case are surrounded by so much obscurity, we consider that it would be unsafe to base action of so drastic a character on this assumption.’

In spite of the apparent anxiety of the Committee to adopt a non-committal attitude on the point, this passage discloses clearly a recognition on their part of the fact that there were other important causes at work that all tended to raise exchange. That some at least of these causes were *sufficient by themselves* to account for the rise in exchange, was practically admitted by Mr. J. F. Findlay, Secretary to the Government of India, in his cross-examination before the Fowler Committee, as the following extract from his evidence will show:—

Q. 2836. Now I want to go back again to the borrowings. I have got here an abstract of the figures taken from the India Office return. In 1894-95 the Government of India paid off Rs. 11,72,338 of debt; in 1895-96 they paid off Rs. 5,84,812; in 1896-97 they borrowed Rs. 33,26,125, that is, exclusive of the two millions from the currency reserve; in 1897-98 they borrowed Rs. 26,75,000. In addition the Government received the following sums from railway companies: In 1895-96 Rs. 1,63,800; in 1896-97, Rs. 3,28,200; in 1897-98, Rs. 7,04,800; and in 1898-99 estimate, Rs. 14,40,000. Then, as regards borrowing, the Government and the guaranteed companies raised in 1894-95 £2,339,765 (that is in London). Then in 1895-96 they raised £939,133. In 1896-97 they raised £2,720,901. Then in 1897-98 they raised £10,138,281. In 1898-99, £488,300. The companies that were not guaranteed raised in those years the following sums: In the calendar year 1894, £475,927; in 1895, £698,385; in 1896, £1,849,444. I have not the figures for the two following years; but in 1897, for the six months up to the 30th June, they raised £463,037, and this year also they intend to

raise a considerable sum. *Now do you think that the borrowing is sufficiently large to account for an appreciable proportion of the rise in exchange that has taken place since 1894-95?—Certainly.*

Q. 2839. Since the mints were closed, the average (of imports of silver) fell off from an average of about Rs. 1,20,00,000 yearly to about Rs. 60,00,000—Yes.

Q. 2840. That is a reduced import into India of Rs. 60,00,000—Yes.

Q. 2841. *That would have an appreciable effect on exchange?—It would.*

The course of events in subsequent years shook the confidence of even officials in the theory. The connection between exchange and the quantity of money in circulation in India was denied by no less an authority than Sir Lionel Abraham in his evidence before the Chamberlain Commission. Asked whether the 'great trouble in Indian exchange arises from the fact that there is such an enormous volume of token coins in circulation', he replied, 'That is a view which has often been put forward, but which I find the greatest difficulty in accepting. *I think the connection between the volume of token coinage and the stability of exchange is very remote*, as indeed is shown by the fact that now, at this moment, the token coinage is of greater volume than ever before, and I think one might almost say that exchange is more stable than it ever has been. According to my view, as I tried to put it in an answer to another member, the stability of exchange depends on *trade conditions*, and the trade conditions may be affected, I admit, but are slowly and indirectly affected, *if at all*, by changes in the volume of currency.'¹

This again is perhaps going too far in the other direction. The truth is, as already shown in chapter iv, that exchange depends not on the price-level in any one country but on *relative* price-levels, measured in prices not of *all* commodities but of only those commodities which enter into international trade. And, although India's imports and exports are large, still in the main, the *inland* prices of products on which the majority of the people live have no close connection with foreign trade, gold, and gold exchanges. The correct doctrine was explained

¹ The italics are ours.

by Prof. Marshall in his evidence before the Fowler Committee as follows :—

Q. 11,788. What do you take to be the general relation between the Indian exchange and prices in India and England?—India is so large that prices at her ports differ widely from up-country prices; and partly for this reason *much of the produce of India is very little connected either as cause or effect with the course of trade.* But, broadly speaking, the Indian exchange, both before and after the closing of the mints, has indicated the proportion *between rupee prices at Indian ports and sterling prices at English ports*; and, subject to allowance for freights, etc. between India and England, the rule holds that the exchange or the gold price of the rupee is the ratio of sterling prices to rupee prices. . . .

Q. 11,789. You say, 'Speaking generally the Indian exchange is the ratio of sterling prices to rupee prices at the ports'. Will you kindly amplify that?—The Indian exchange is quoted as the sterling price of the rupee, that is, as the price in London of the command of a rupee's worth of goods in Calcutta or Bombay. If the exchange is not by telegraph, something must, of course, be allowed for interest. It is worth the while of an English importer of, say, jute, to pay this price for a rupee if the jute that he can get with a rupee will sell *net* in London for this price. By *net* is meant, after paying all the expenses; i.e. including insurance, interest for the time the capital is locked up in transit, and remuneration for himself. Thus Indian exchange is the ratio which the sterling price of jute, after allowing for freight, bears to the India price. In the same way, the exchange is the ratio that the sterling price of calico bears to the Calcutta price after allowance is made for freight, etc. The details of this had, perhaps, better be taken separately for the case in which the imports of silver directly affect the currency of India, and the case in which they do not. The latter case is really the simpler.

Q. 11,790. Now, will you say how this works out?—Since the mints were closed, the currency of India has consisted of Government notes printed on silver. Their value is governed in the main by their amount relatively to the work which they have to do, account being taken of the fact that apprehensions as to the stability of value of such a currency will affect the

amount of the purchasing power which people care to keep directly or indirectly in the form of currency. The Indian exchange is then governed by the relation between gold prices and rupee prices, being, in fact, an expression of the ratio between them.

As explained in chapter iv, the relative price-levels determine only the *normal* rate of exchange. Deviations from the normal are possible on many grounds, one of the most important being the *balance of accounts*. The peculiarity of the Indian system has been that the balance of accounts has been repeatedly turned in favour of India, on account of *heavy and continuous borrowing* in London, so that what would have been, in the absence of a change in the relative price-levels, only a temporary phenomenon, has *appeared* to be a normal feature. But the fundamental cause at work has throughout been the ratio between the price-levels at the ports.

CHAPTER XI

A GOLD STANDARD WITH GOLD AS CURRENCY IN INTERNAL CIRCULATION

1. In chapter v, we noticed briefly the recommendation of the Fowler Committee in favour of 'throwing the Indian mints open to the unrestricted coinage of gold on terms and conditions such as govern the three Australian branches of the Royal Mint', and traced the development of the Indian currency system along lines which, though different from those suggested by the Fowler Committee, were subsequently approved of by the Chamberlain Commission in 1913. The majority of this Commission subjected the proposals of the Fowler Committee to searching criticism, and arrived at the conclusion that 'it would not be to India's advantage to encourage an increased use of gold in the internal circulation.' This authoritative approval of the existing system gave a serious set-back to the proposal for establishing a gold currency in India, which was regarded even in official circles as late as May, 1912, as 'the logical and natural consequence of the closing of the mints to silver, and as the necessary accompaniment of the establishment of a gold standard.' The decision of the Commission was thus a challenge to widely accepted views, and consequently gave rise to a prolonged controversy which has not yet been laid to rest. It is necessary therefore to note the main points at issue in this controversy.

Some of the main arguments in favour of a gold currency were summed up by the Chamberlain Commission as follows: (1) That gold is a more convenient and portable medium of circulation than the rupee; (2) that gold currency is a necessary step towards what may be regarded as the ideal currency, namely, paper backed up by gold in reserve; (3) that some prestige attaches to the possession of a gold currency, whereas a silver circulation is the mark of less progressive peoples; (4) that a large amount of gold in circulation is a strong, and in the view of some people, the only adequate, support for exchange;

(5) that the constant mintage of fresh supplies of rupees is objectionable, and would be obviated by an increasing circulation of sovereigns ; (6) that, until India has a gold currency in active circulation, India will continue to possess an artificial and managed currency.

Each of these arguments was criticized severely in the report signed by the majority of the Commissioners ; and their adverse criticism in its turn called forth a well-reasoned rejoinder from Sir James Begbie, the only dissenting member. It is best, therefore, to take up each of these arguments separately, so as to bring out clearly the points of difference between the opposing views.

2. The first point raised the important question as to the real preference of the public. Both sides were agreed on the general principle that the extent to which a particular coin should be put into circulation, must be decided solely in accordance with *India's own needs and wishes* , and that ' it would be unjust to *force* ' gold or rupees in circulation in India. But, while the majority held that ' India must continue for many years to use rupees for payment of the *small amounts* which form the *bulk* of *internal transactions* ', the dissenting member laid stress on the fact that ' the public had absorbed during the last twelve years approximately *equal* amounts of rupees and sovereigns ', and that the ' *demand* for sovereigns had rapidly *increased* ' during the preceding four years, and contended that ' these recent gold requirements showed an important change in the currency needs of the people ', and indicated ' a *preference for gold* over rupees.' The question therefore resolved itself into one of interpreting rightly the significance of the figures relating to the amount of gold absorbed into India. Mr. Keynes, one of the members of the Commission, took up the position that the gross figures of gold imports into India were not at all *relevant* to the question, as part of that amount was used for ornament, part for hoarding, and part was melted down ; and that it was only the part that was employed as *currency* that could show the preference of the public for gold currency. He contended that the evidence, such as was available, went to show ' the existence in India . . . of an enormous demand for *gold bullion*, a very

considerable demand for sovereigns for the purposes of *hoarding*, and a *relatively smaller* demand for them, confined chiefly to the United Provinces, the Punjab, Madras, and Bombay, for purposes of *currency*.'

A fair-minded reader of this evidence will find it difficult to resist the conclusion that the interpretation put by Mr. Keynes on the available statistics is really the right one. Common observation, as well as the known poverty of the bulk of the people, alike support the view that the bulk of internal transactions in India will continue, for a long time, to involve small amounts for which gold will hardly be a suitable coin. Even the majority of the Fowler Committee, who declared themselves in favour of making the British sovereign a legal tender and a current coin in India, had no illusions on the point; they frankly admitted that 'there was little or no likelihood, even according to the most sanguine view, that for a long time to come gold coins, even if declared a legal tender forthwith, would find their way to any great extent into general circulation.' Indian publicists like Sir D. E. Wacha spoke from the platform of the Indian National Congress (1898) in a similar vein: 'For, consider how you may, you cannot help admitting the fact that, bearing in mind the poverty of the people and their immemorial habits and usages, gold can never become the currency. Silver alone is suitable and convenient. It is the natural currency.' And several witnesses before the Fowler Committee pointed out that 'for the man in the street and the man in the village or the village shop, a gold coinage would be absolutely useless.' Again, if the history of the past is any safe guide in such matters, the figures of gold and silver coinage during the period 1801-35, a period when gold was coined freely, and both gold and silver were legal tender—a period which is often referred to by the advocates of gold currency as showing the popularity of gold coinage—seem to support the contention of Mr. Keynes, for during these years, while the silver coinage amounted to £63,631,833, gold coinage was only £11,060,148.¹ We have no further statistics to rely upon except those commented on by Mr. Keynes, as the figures since 1914 lead us nowhere, owing to the abnormal conditions prevailing since then, and the almost

¹ *Vide* p. 622, vol. ii. Appendices to the *Report of the Chamberlain Commission*.

universal restrictions on the free movements of gold during the greater part of the war and the post-war periods.

This line of reasoning is, however, not as conclusive as it may appear at first sight. As Sir James Begbie pointed out, an extensive token currency 'has the usual effect of driving gold out of circulation.' No fair inference as to the public preference for gold can therefore be safely drawn from the small amount of gold in circulation under such conditions.

Nor is it proper to draw any very sharp distinction between the sovereigns hoarded and those in active circulation. The so-called hoards may be used as money more often than the term is usually held to imply.¹

Similarly, one cannot rely absolutely on the argument based upon the poverty of the people of India. We may on this point cite the high authority of Prof. Marshall, who in his evidence before the Gold and Silver Commission said, 'It is commonly said that poor districts would not be likely to use much gold. That may be so but there is *no certainty about it*. The use of gold seems to depend on habits which are not easily traced and measured statistically, but which are perhaps closely connected in some parts of the world with the hoarding of gold. For instance, more than 80 per cent of the value of coins in circulation in some of the poorest parts of France consists of gold, while in some of the richer districts the value of gold in circulation is less than that of silver' (Q. 9674).

The truth is that the public preference for one coin to the other can be conclusively proved only when the *public is free to convert* one into the other. The rupee in India was not freely convertible into gold during the period on which Mr. Keynes relied for his figures; the absorption of a large amount of rupees as currency during that period does not therefore negative the idea that the public would have converted them into gold if they had been free to do so. If Government was sure of the fact that the public preferred rupees, there was no risk whatever in making the rupee freely convertible into gold. The unwillingness of Government to assume a positive obligation for the convertibility of the rupee *internally* raised a presumption that Government feared that the public would prefer gold to rupees,

¹ See Mr. Howard's note of evidence to the Chamberlain Commission.

as internal currency. The only decisive rebuttal of the critics' case lay in the bold assumption by Government of this obligation to convert rupees into gold; but this Government has all along declined to do.

Nor was *the real contention* of the critics of the Indian Currency System *fairly met* by this line of argument. No one grudged the rupee the position that cheques or notes occupied in advanced European countries. The real point to which the critics were driving was an arrangement under which the rupee would be freely convertible into gold, just as cheques were in England and notes in Continental countries. Only a minute fraction of the population in European countries had any occasion actually to handle a gold coin; and yet nobody had ever suggested that on that account cheques and notes should be declared inconvertible into gold. Similarly, the masses in India may continue to use silver currency in their everyday life; but that was hardly a reason for refusing them the right to have their token coins converted into gold when they wished to do so. Again, if the bulk of transactions involve only small amounts why need the rupee be *unlimited* legal tender at all? No advocate of a gold standard and a gold currency ever objected to the popularity of the rupee as the chief medium of exchange, if it were only limited legal tender or freely convertible into gold. The argument of Mr. Keynes was no answer to contentions like this. But for this evasion of the real points at issue, the confusion in the minds of the advocates of a gold currency was not a little responsible; they failed on the whole to make their position clear.

3. In refutation of the second argument, the majority attempted to show that history gave no support to the view that a paper currency could be reached only after a gold currency had been in circulation, and urged that 'a paper currency, if readily encashable, was the most economical medium of exchange and at the same time provided a readily available reserve of gold for foreign remittance.'

No exception could possibly be taken to this general statement, but a critic may fairly deny its applicability to the Indian Currency System. The Indian currency note was readily encashable *not in gold* but in *rupees*, which were practically inconvertible notes printed on silver. In effect,

it was very much therefore on a par with inconvertible paper currency—by no means the best means of educating people in the use of more economical forms of currency than gold. Nor did the system provide a readily available reserve of gold for foreign remittance, as quite a substantial part of the Paper Currency Reserve consisted of silver, rupees and securities.

Far from educating people properly in monetary matters, Sir James Begbie rightly contended, the present system had just the opposite effect. It kept gold out of useful employment. People who prized gold so highly as to store and hoard it were not likely to invest it so long as they had to take the risk of being repaid in token coins. What was needed was 'not education in the use of economical currency so much as education in the use of store of gold'; and this was not possible so long as there was an extensive and expanding token currency. 'A currency in which gold was a more prominent feature, and to which token coins were less freely added, would be more practical as an educative force. Gold coins would be suitable and convenient for many ordinary currency purposes, and by using them the public would be gradually led to use gold for the other purposes, such as investments, especially if a considerable circulation of gold existed, sufficient to inspire the public with confidence that when they wanted their gold restored to them they could get it.'¹

4. As regards the third argument, the majority drew a distinction between a *gold standard*, which, they admitted, had become a mark of progressive people, and 'a *gold currency* in the sense of a preponderating use of gold for internal exchanges', which, they contended, was not a characteristic of a single one of the great Powers of the world, all of whom used either cheques or notes for internal transactions. In their opinion, the Indian Currency System was not in actual practice different from the currency systems of such countries as Russia, Holland, Japan, or Austria-Hungary, for 'in these countries as in India, gold actually in circulation is of secondary importance, and the internal medium of exchange, whether it be a silver coin or a paper note, depends for its value in exchange, not on its own

¹ Sir James Begbie's Minute of Dissent,

intrinsic worth, but on the maintenance in reserve of gold or resources readily convertible into gold, and, in the case of Russia and Japan at any rate, large portions of gold resources are held not at home, but in London, Paris, and other monetary countries, just as India's Gold Standard Reserve is held in London.' (Para 51.)

The dissenting member, on the other hand, considered such analogies 'unsafe as a guide to Indian policy because the conditions were not identical.' 'In none of the countries', he pointed out, 'is there the same private absorption of gold that there is in India. Whatever experience elsewhere may be, the recent demands for gold in India show a loss of confidence on the part of the public in the token coin, and that is a situation that cannot be ignored.' Thus, on analysis, we come back to the vital question of the public preference for gold or silver, which we have already discussed at length.

5. The fourth argument called for a somewhat elaborate comment from the majority. They admitted that a considerable quantity of gold would be available for export at times of weak exchange, if gold was used in active circulation to the same extent as it was in Egypt; but pointed out that this was not possible, unless a large amount of rupees was withdrawn from circulation, and the note-issue reduced to a comparatively insignificant position. If, however, all that the advocates of a gold currency really contemplated was an addition of gold coins to the *existing* circulation of notes and rupees, the Commissioners feared that the policy of popularizing gold as currency, instead of helping exchange, might jeopardize it. For gold, in that case, would for many years to come occupy only a subsidiary position in the Indian Currency System, and it would be the surplus rupees and not the gold in circulation that would seek an outlet in time of depressed trade and weak exchange. The only effect of infusing more gold into circulation would be to weaken the Government reserves of gold: if gold replaced rupees, the Gold Standard Reserve would cease to grow; if it took the place of notes, the Paper Currency Reserve would be diminished.

In the opinion of these Commissioners, the view that gold in active circulation was a support to exchange, was based on a misreading of the currency history of modern England or

Germany. 'The ability of these countries to meet at all times their immediate foreign indebtedness', they went on to say, 'depends on the *central reserves* of the banks of these countries, on the *influence* exerted by these banks on the other constituents of the *money market*, and on their *bank rate* policy. It is not possible to point to any occasion in contemporary history on which *sovereigns in the pockets of the people* have proved a resource on which to count for easing the situation, when a monetary crisis threatens the Bank of England's gold reserve. . . . 'It is useless to suppose that the advantages of the existing monetary system of the United Kingdom can be obtained for India by imitating what is, perhaps, the *least vital part* of this system, namely, the use of sovereigns for that small class of payments which are made in actual cash, while ignoring the nature of the *complex banking and financial system* upon which the stability of exchange really rests.'¹

Sir James Begbie, on the other hand, contended that, though gold in reserves was better than gold in circulation for the support of exchange, gold in circulation was a better protection for exchange than token coins. Moreover, reserves of gold could be accumulated from a gold circulation through the note-issue and a good banking organization. 'Even under the existing system,' he pointed out, 'the most satisfactory part of the gold reserves is the gold in the Paper Currency Department. The full equivalent of the currency issued against it is saved in gold for the reserve, whereas the Gold Standard Reserve represents only about one-third of the token currency from which it was saved, and will redeem only that proportion of it, unless the extreme step is taken, of melting down rupees. Also, a considerable portion of the coin reserve of the Note Department must be held in rupees at present. With a free circulation of gold a much smaller portion can be held in rupees and a correspondingly larger part in gold.'

To these considerations we may add two more points. The majority rightly laid great stress on adequate banking and currency *reserves in gold*, as supports to exchange. But was it not idle to expect the banks to keep their reserves in *gold* bullion or coin when silver was the ordinary currency of the

¹ The italics are ours.

country? Was not Government under the existing system taking upon itself the entire burden of keeping adequate gold reserves for foreign drain, part of which at any rate was likely to be shifted to the banking organization of the country under a system of gold currency with rupees as *limited legal tender*?

It is again quite legitimate for the advocate of a gold currency to contend that the paper currency will command greater confidence with the public when it is legally convertible into gold than it does under the existing system, when it is encashable freely only in token rupees. He may well argue that, far from depleting the Paper Currency Reserve, the establishment of a gold currency would in the long run give India a much stronger Paper Currency Reserve in gold, owing to the greater popularity and expansion of the note-issue.

We may then fairly conclude that reason and logic on this point are more on the side of the advocate of gold currency than on the side of his opponents.

6. The majority in their examination of the fifth argument pointed out its close connection with the preceding one. 'for the possible danger to exchange of a very large circulation of token' was the main ground of this objection; and they expressed their conviction that the increased use of sovereigns as currency was 'almost certain in the long run to militate against the use of notes,' as in many respects gold was 'a far more formidable rival to the note-issue than to rupees.'

There is no doubt there was an element of truth in this view. So long as confidence in the note-issue was not fully established in India, people would continue to prefer gold to notes. But this preference for gold would be very much less if notes were declared convertible into gold, rather than into artificially valued rupees. 'The greater convenience of convertible notes was bound to tell in the long run; and, as Sir James Begbie pointed out, 'notes will usually be preferred to coin—whether gold or silver—for such purposes as bank cash reserves and frequently for effecting remittances.' The establishment of a gold currency would bring India nearer the stage when notes would be convertible into gold, and would thus tend to increase public confidence in the note-issue rather than diminish its circulation.

7. The sixth argument in favour of a gold currency evoked from the majority a rather spirited protest. They thought that

'the only point of the criticism, that India's currency system is managed in a sense that is not true of the currency of the United Kingdom, lies in the fact that the rupee is a token passing at a value above its intrinsic value, and at the same time is unlimited legal tender.' Except in this respect, the Indian system appeared to them as automatic as that of the United Kingdom, for in their opinion there was no essential difference 'between the power to import sovereigns at will and the power to have gold coined into sovereigns in India.' They denied that the Government of India had any power to 'manipulate the currency for their own ends' or 'add to the active circulation of the currency except in response to public demands.'

This was practically a re-echo of the views expressed by Mr. Keynes in his book, *Indian Currency and Finance*. He had warmly protested against the idea that 'the volume of currency in circulation depends upon the policy of the Government or the caprice of an official', and contended that, in case the Secretary of State did not sell Council Bills in response to the demands of trade, people would import sovereigns into India, demand from Government rupees in exchange for them, and so effect the same increase in the volume of currency as would have been caused by the sale of Council Bills.

It is not difficult to see the fallacies involved in this line of reasoning. Under the existing system the currency of India is expanded, not in response to the demands of trade as a *whole*, but only of a part of that trade, namely, *external trade*. If during any period the balance of trade in favour of India increases rapidly, the sale of Council Bills receives a stimulus, and the amount of rupees or notes in circulation is augmented thereby out of all proportion to the real increase in the *total trade* (external and internal), for the internal trade does not necessarily grow in proportion to the growth in India's favourable balance of trade. Thus the system increases the total purchasing power much more than a real automatic system would.

Even this statement needs an important qualification. India is a land of seasons; and it is only in the busy season that there is a keen demand for Council Bills, necessitating fresh coinage or further issue of paper money. Thus the currency of India is expanded, not in response to the growth in external trade

throughout the year, but only in proportion to the demand for funds for financing export trade during the busy season.¹

The truth is that the idea underlying the whole system, that the *rate of exchange* is the test of deficiency or redundancy of the currency, is wrong and mischievous. Exchange may be the measure of the temporary requirements of foreign trade, but it is the rate of discount that is the proper index to the temporary requirements of India's internal trade. Exchange may show the scarcity or abundance of currency in one country as compared with another; but it is the fall or the rise in the price-levels of a country that reveals the insufficiency or redundancy of the currency for the *normal* requirements of its total trade.

The argument of the apologists of the present system seems further to assume as an axiomatic statement that Government cannot coin rupees except in exchange for gold. That this is not a correct statement of fact was brought out clearly in the cross-examination of Sir James L. Mackay (now Lord Inchcape) before the Fowler Committee, as the following extract will show:—

Q. 268. (Sir David Barbour) I think the Government has power at present to coin rupees if it likes?—They have the power of coining rupees and issuing them to the public in return for gold.

Q. 269. But the Government actually did coin rupees out of the silver taken over from the banks?—Yes.

Q. 297. Am I right in taking your sentence as meaning that there is no power in India for issuing full legal tender except against the payment of gold?—That is so.

Q. 299. But the Government can coin silver which it takes over from the banks, and even when old rupees come in the Government can re-coin them?—Of course.

Q. 304. (Lord Balfour of Burleigh) On the last point on which there was some discussion, it is the fact, is it not, that, under whatever power it was done, the Indian Government did accept for coinage silver to the value of about two crores?—Yes, they did that by executive order.

These revelations only served to emphasize the force of the following remarks made by the Lord Commissioners of the Treasury on the proposal for closing the mints in 1886: 'The

¹ See Mr. Donald Graham's evidence before the Fowler Committee. See Lord Abraham's evidence before the Fowler Committee.

proposal appears open to those objections to a token currency which have long been recognized by all civilized nations, namely, that, instead of being automatic, it must be " managed " by the Government, and that any such management not only fails to keep a token currency at par, but *exposes the Government* which undertakes it to very serious difficulties and *temptations*.' We need hardly repeat that few temptations are more difficult to resist than the temptation to inflate the currency.

We have so far looked at only one side of the working of the Indian system, the way in which it increases the volume of the currency. But a satisfactory system of the currency is automatic in the reverse direction also. In gold-using countries before the war, gold coins were easily exported, or melted and withdrawn from circulation, when trade was slack. This automatic process of contraction has all along been wanting in the Indian system. *Legally* the rupees have never been freely convertible into gold inside the country ; nor are they externally convertible except on those rare occasions when Government sells Reverse Councils at times of weakening exchange. And exchange, as we have already seen, is capable of being influenced by many factors, other than internal conditions of trade. Trade may be depressed, and currency may be redundant, and yet heavy and continuous borrowing on the part of India may reverse the tendency to weak exchange, and make recourse to Reverse Councils unnecessary. Prices may rise in India, and yet exchange may not only remain stable but even *rise* because of greater *inflation* in other countries.

It is true that the rupee was not absolutely inconvertible into gold inside the country, for in pre-war days the Indian Government did at times offer gold for rupees. But there are varying degrees of inconvertibility. The very essence of the gold-exchange standard lies, according to one of its best exponents, in ' some degree of *unwillingness* to supply gold locally in exchange for the local currency ; but a high degree of willingness to sell foreign exchange for payment in local currency at a certain maximum rate.' This in itself implies some *inconvertibility* in actual practice. But, even if the rupee were a *convertible* note printed on silver, its *low denomination* would make it *de facto inconvertible*. Add to this the fact that against this note, printed in silver, Government keeps no reserve in *gold* to ensure its

convertibility, apart from what they consider necessary for supporting the paper currency notes and the foreign exchange, and the degree of its inconvertibility becomes all too patent. The rupee at best has only an 'imperfect or impeded convertibility';¹ and its over-issue is on that account just as likely as that of inconvertible notes.

The Commissioners' line of reasoning is open to another serious objection. They seem to have taken it for granted that it was a matter of indifference to the London money-market whether gold actually flowed into India from London or not, and that the cessation of the sale of Council Bills would not affect the very trade-demand in response to which they are supposed to be sold. Such an assumption does not appear to be warranted by facts. Gold has never been so abundant in London that ten or fifteen millions could be drawn from it, during the busy season, without affecting its discount rate and creating a stringency in its money-market. Even the official witness, Mr. J. E. O'Connor, was forced to admit before the Fowler Committee the connection between the Secretary of State's drawings and the activity of the Indian export trade, and said in his cross-examination: 'I do not know how the thing comes about, but we know that it has happened on *every* occasion when the Secretary of State's drawings have been suspended, that the export trade has been suspended; export business has ceased for the time being.' It is significant to note in this connection the extreme solicitude for the interests of the London money-market betrayed by Mr. Lindsay, the originator of the gold-exchange standard. When asked by Sir David Barbour whether he thought that the establishment of a gold currency would lead to an injurious appreciation of gold, he replied as follows: 'I think myself, that the two uses of gold combined—for hoarding and for internal circulation—would be so enormous that it would *create a serious disturbance in the London money-market*.'² His further cross-examination revealed the same anxiety:—

Q. 4232. Now you say that, under the system proposed by the Government of India, if gold circulated in India, there would be heavy *withdrawals*, every busy season, of gold from

¹ See Nicholson's *War Finance*.

² Q. 3593. Minutes of Evidence before the Fowler Committee.

London?—I should have said that there is a risk of heavy withdrawals during any time of active export trade.

Q. 4233. Do you think that gold would go back again or remain in India?—I think that gold to a great extent would remain in India.

Q. 4234. Would not there be the same or a similar demand for the gold in London under your scheme in a busy export season. People would pay in gold at 1s. 4½*d.* in order to get rupees?—The difference would be this, that *gold would not* be drawn from London for currency purposes in India. The gold would be transferred from certain accounts in the Bank of England to the gold standard office account, and in the autumn here, i.e., in the slack season in India, a re-transfer would take place; but *the gold would not leave the Bank of England for currency purposes in India.*

Q. 4236. You would propose, then, that the gold paid into the gold standard reserve should not be set aside specially to meet claims against it, but that it should be merged in the general balance of the bank which it might use for any purpose?—Yes, that would be the best way. There would be no disturbance then of the London money-market.

A similar admission as to the real effect of selling Council Drafts was made by Mr. F. W. Newmarch, Financial Secretary, in his memorandum to the Chamberlain Commission. Among the advantages claimed for the practice of selling Council Bills to meet the convenience of trade he mentioned the fact that 'it serves, sometimes, to avert *extreme stringency* in the London money-market, which would be created if the Secretary of State, by refusing to sell drafts for the convenience of trade, forced large quantities to be taken from London for India.'¹

The majority emphatically asserted that the Government cannot manipulate the currency for its own ends. But, as Prof. Nicholson rightly pointed out, 'the very *basis* of the whole system is that Government adopts the system so as to secure stability of exchange *for its own convenience*. The mints were closed to raise and maintain the exchange, and the complex arrangements for keeping a reserve, and the nature and the *locale* of that reserve, *have all been guided by the ends of the Government*. So long as

¹ Appendix vii, p. 223.

the rupee maintained its value in gold payable in London, the rest of its monetary functions were either not considered at all, or were supposed to follow by some kind of pre-established harmony inherent in the gold-exchange standard.¹

Finally the Indian currency system is managed in the sense that it impedes the automatic working of the natural correctives to favourable and unfavourable exchange.² When the United States has a favourable trade balance and gold flows from London to New York in adjustment of this balance, gold prices tend to *rise* in the United States and *fall* in England. This stimulates exports from England to the United States and tends in its turn to bring about a rate of exchange favourable to London. When India has a favourable trade balance, the sale of Council Drafts tends to raise prices in India but does not produce a fall of prices in England, as gold does not leave England.

The examination of this controversy thus leads us to the conclusion that, except on the vital question of public reference for the rupee as a convenient and portable medium of circulation in India, the reasoning of the Chamberlain Commission is open to effective refutation.

¹ Nicholson's *War Finance*.

² See the evidence of Mr. Morton Frewen (Chamberlain Commission).

CHAPTER XII

STABILITY OF THE RUPEE IN TERMS OF PURCHASING POWER

1. In the last chapter we noticed among the arguments for a gold currency a charge of artificiality against the pre-war currency system, and indicated our reasons for sustaining that charge in spite of the defence of Mr. Keynes and the Chamberlain Commission. In the present chapter we propose to show the connection between the failure of the currency machinery to provide for automatic contraction, and the phenomenon of high prices in India during the period 1893-1922.

As to the rise of prices there is not the least doubt whatever. The following table compiled by the Department of Statistics shows the course of prices in India, and is well worth a detailed study :—

Prices in India expressed in Index numbers

(Prices in 1873=100)

Year	Exported articles (28) unweighted	Imported articles (11) unweighted	General index number for all 39 articles unweighted	Weighted index number (100 articles) equated to 100 for 1873
1861	88	85	90	93
1873	100	100	100	100
1874	102	99	101	108
1875	95	90	94	96
1876	90	91	90	100
1877	110	88	104	129
1878	114	84	106	138
1879	112	83	104	126
1880	110	88	104	109
1881	99	86	96	99
1882	95	85	92	98
1883	93	79	89	99
1884	96	78	91	107
1885	91	75	87	106
1886	93	80	89	103
1887	94	83	91	104

Year	Exported articles (28) unweighted	Imported articles (11) unweighted	General index number for all 39 articles unweighted	Weighted index number (100 articles) equated to 100 for 1873
1888	98	92	96	111
1889	104	91	101	117
1890	104	91	100	117
1891	103	84	98	120
1892	109	84	102	132
1893	112	89	105	129
1894	110	84	102	122
1895	111	87	104	120
1896	117	94	110	131
1897	124	86	113	153
1898	102	80	96	125
1899	100	87	96	121
1900	124	96	116	143
1901	116	96	110	139
1902	113	86	106	128
1903	103	88	99	122
1904	104	93	101	121
1905	116	96	110	135
1906	139	105	129	158
1907	145	116	137	167
1908	161	106	138	179
1909	133	99	124	160
1910	127	109	122	150
1911	136	113	129	155
1912	145	117	137	174
1913	154	117	143	182
1914	160	114	147	187
1915	155	146	152	182
1916	163	236	184	185
1917	170	262	196	186
1918	199	289	225	215
1919	277	274	276	301
1920	281	280	281	302
1921	239	228	236	273
1922	245	209	235	266
1923	224	210	220	252

The salient facts to note in this table are :—

(1) The steadiness of the price-level during the period 1873-87.

(2) An upward tendency of prices during the five years prior to the closing of the mints, particularly in the year 1892.

(3) The comparative steadiness of the quinquennial average, in spite of annual fluctuations of prices during the decade 1893-1902.

(4) A continuous and rapid rise in the price-level during the succeeding four quinquenniums (1902-22).

2. The period 1873-93 may be dismissed briefly. It was a period of falling exchange (as shown in the table on page 33) but of steady price-levels. A detailed examination of the facts of the period does not support the common official view that, if the mints had been kept open to the free coinage of silver, exchange would have fallen continuously and produced an unprecedented rise of prices in India. Exchange fell from 1s. 10³⁵/_{d.} in 1873 to 1s. 7⁵³⁶/_{d.} in 1883, but the price-level during these years did not rise at all, on the contrary, it fell from 100 in 1873 to 99 in 1883. There was a drop of another threepence in exchange between 1883 and 1887; the index number of prices rose, but only to an inappreciable extent. During the five years prior to the closing of the mints, a much smaller fall in exchange was accompanied by a much greater rise in prices than during the period 1883-87. Again, during the two years after the closing of the mints, exchange weakened, but the prices showed a fall and not a rise. It is plain that the critics of the silver standard have overshot their mark and at best over-emphasized only one among the many elements in the problem.

It is interesting to note in this connection that, during the period 1883-88, it was not so much the rise as the fall of prices that was feared most by people. When asked whether in his opinion the prices of Indian products must fall under a gold standard, Mr. J. E. O'Connor replied to the Fowler Committee as follows: 'It is partly a question of argument and partly a question of fact. All I wish to say about it is this: the prices of Indian produce may fall under a gold standard, but they have fallen under the *silver standard*. On the assumption which underlies the opposition to the closure of the mints, the fall in prices would probably be extremely accentuated if the silver standard were maintained, because it is argued that a silver standard tends to stimulate production. If it does so, there must be a fall in prices; so that, whichever way you take it, whether we have the gold standard or the silver standard, there is practically no difference between the two in regard to the course of gold prices for the products which we export to gold countries.' Considerations like these clearly show that the silver standard was not so inconsistent with steady, or even falling, prices, as the apologists of the present system have attempted to make out.

3. The course of prices during the years 1894-1912 was the subject of investigation by Mr. Datta of the Indian Finance Department, and it will be convenient to make his report the basis of discussion as to the causes of the rise of prices during that period.

The report pointed out that 'prices have risen in almost all the chief countries of the world as well as in India, but the *rise in India*, in recent years, has been *greater than in any other country*', and it divided the causes of this rise into two classes, namely, (1) causes peculiar to India; and (2) causes that had influenced the price-level throughout the world.

It seemed to attach greater importance to the second than to the first group of causes, though this was inconsistent with its conclusion that the rise of prices in India had been greater than in any other country.

Of the causes peculiar to India, the first place was assigned to the shortage of food production as compared with a very greatly increased demand for it. Several reasons were given in support of this view. Population had increased by a larger percentage in the period under enquiry than either the total area under cultivation, the area under food-grains, or the total production of food-grains; the growing demand for jute, cotton and other commercial crops had led to the substitution of non-food crops for food crops, and 'unseasonable and deficient rainfall, during the period under enquiry' had also contributed 'in no small measure to a shortage of production'.

Next in importance among the causes in this group was supposed to be an increased demand for commodities due to an increase in the standard of living of a large section of the people, specially those who were engaged in the cultivation of jute, cotton, oil-seeds, and wheat.

The third cause was alleged to be 'the development of communications, and the lowering of the direct and indirect costs of transport in India itself and between Indian ports and foreign countries', which had linked prices in Indian ports to those of the world markets, with the result that 'prices in inland districts had been levelled up to those at the ports in a greater degree than was previously the case.'

The Enquiry Committee rejected the suggestion that the volume of currency (rupees and notes of lower denominations

than 1,000) had exercised an important influence on the level of prices in India, on the ground that the figures collected by them showed that the circulating medium apart from credit had increased only 60 per cent in volume as compared with 120 per cent increase in the growth of business. They admitted, however, that the remarkable growth in monetary and banking facilities, and in the development of credit, had exercised considerable influence on prices.

Among the world causes that had indirectly affected the Indian price-level, the Report mentioned only two, namely, (1) the development of credit due to the increase in gold supply; (2) the destructive wars and the increase in armaments, which had diverted capital and labour to unproductive purposes.

4. The Resolution of the Government of India on this Report rightly questioned the correctness of the data on which Mr. Datta's first conclusion was based. It pointed out that the figures relied on by the Enquiry Committee were 'largely conjectural and uncertain', and that the returns for the tracts for which relatively accurate information was available showed clearly that the area under cultivation had expanded more rapidly than the population. It further drew attention to the fact that 'the cultivated area at the close of the period under review included irrigated land to a considerably greater extent than at the outset', and urged that 'the consequent improvement of out-turn and increased certainty of securing it must have more than counterbalanced any slight defect in area as compared with population, if indeed any such defect had existed.'

As to the substitution of non-food crops for food crops, the Enquiry Committee had themselves admitted in para. 175 of their Report that the total area which commercial crops had occupied at the expense of food grains was *very small* as compared with the total area under cultivation of food crops, and that consequently the effect of that substitution 'could not have been *very great*.'

But the fundamental error in Mr. Datta's reasoning on this point proceeds from a confusion of ideas in his theory of prices. In paras. 221 to 227 of the Report, he accepts the theory outlined in chapter ii of this book and sums it up correctly as follows: 'When all these factors have been allowed for, prices are determined by the relation *between the volume of the purchasing medium*

in terms of money and the quantity of goods. The volume of the purchasing medium is, however, by no means the same as the volume of specie, or what is generally called money. This purchasing power includes not only specie, but bank (or currency) notes and credit as well.' But when he comes to apply this theory, he forgets this explicit statement, and reasons as if the price-level depends on the relation between the *quantity of goods and population*. If population had grown at a more rapid pace than production, there would have been a fall of *real* wages in India—a fact that is inconsistent with the view expressed in the Report that 'there has been a large increase in the demand for *all* kinds of commodities on the part of consumers in India.' He admits that *food supply had increased* and that *business of all kinds had expanded*; in other words there was an increase in T in the equation $P = \frac{T}{M V + M^1 V^1}$. Other things being equal, this would have tended to increase P , the purchasing power of the rupee, and so produce a *fall of prices*, and not a *rise*. Whether food supply had increased in the same proportion as population or not, is a question absolutely irrelevant to the discussion of a *general rise* of prices in India. Even if commercial crops had taken the place of food crops, that could only have caused an increase in the price of food grains *relatively* to the prices of other crops; it could not have caused a *general rise of prices in India*.

5. Mr. Datta's second conclusion is open to a similar objection. It is difficult to reconcile the proposition that the production of food supply had not kept pace with the growth of population, with the statement that 'a noticeable change had taken place in the style of living of *all* classes of society, upper, middle and lower, and the demand for *all* kinds of the necessities of civilized existence in regard to *food*, clothing, housing, education and society had increased.' But, apart from this inconsistency, there is a more serious error in his argument. Increased consumption is impossible without increased production; and to make the purchase and sale of larger quantities of goods possible there must take place either an increase in the medium of exchange or a *fall of prices*. For if in the equation $P = \frac{T}{M V + M^1 V^1}$, T increases, P must increase or, what

comes to the same thing, prices *must fall* in the absence of any change in the denominator. It is true that an increase in the demand for any *particular* commodity will cause a *rise in its* price ; but in this case we are comparing only one commodity against all other goods, including the medium of exchange. A *general* increase in the demand of all commodities is, however, impossible without an increase in supply ; and this *by itself* unaccompanied by an increase in the medium of exchange must produce a fall and not a rise of prices.

6: As to the third cause, there is no doubt that it sent up the prices of export-commodities in inland districts ; but at the same time it must have increased T and so tended to produce a *fall of prices*. The only force capable of neutralizing this tendency was an increase in V and V' ; but the authors of the Report explicitly state in para. 234 that ' they have had no evidence of any change in the rapidity of the circulation of currency and credit during the preceding two decades.' At its best then, this cause was a very inadequate explanation of a *general rise of prices all over the country*.

7. There remains the last point to consider. We may at once concede that there was an appreciable growth of credit in India during the period under enquiry ; but the basis of that credit could only have been rupees or notes, and the amount of credit must have borne some definite ratio to cash. And the volume of cash was determined, not by the operations of natural and automatic forces under a system of open mints, but was regulated by Government. In these circumstances it is not possible to separate the effects of credit on prices from those of currency.

At any rate, the extension of credit could not have been a factor of first-rate importance in the rise of Indian prices, for the bulk of our transactions here are in cash and not credit. Banking in India is still undeveloped ; the use of cheques outside the Presidency towns is rare ; and even in the Presidency towns the proportion of *commercial*, as distinguished from *banking*, transactions, in which cheques are used, to the total volume of business is extremely small. The real explanation of the phenomenal rise of prices in India must therefore be sought elsewhere.

The Enquiry Committee rejected the suggestion that the

volume of currency had anything to do with the rise of prices, on the ground that the volume of business had increased far more than the volume of money. But the figures that form the basis of this conclusion are not at all reliable. In the first place, Mr. Datta's estimate of our monetary circulation includes neither (a) the circulation of sovereigns, nor (b) the circulation of small silver coins. Secondly, Mr. Datta's index number of the growth of business is estimated on an entirely wrong basis. In measuring the volume of exchange—work that the monetary tools of a country have to do—it is the *physical volume* of business and not its monetary *value* that really matters. The statistics used for this purpose should be statistics of *physical quantities* and not of prices, since the movements of the price-level are among the results of inflation. But in some of the items that enter into Mr. Datta's estimate, it is the *values* and not the physical quantities that are taken into account.

In the last chapter we remarked that the expansion and contraction of Indian currency was not as natural and automatic under the gold-exchange standard as it was under the silver standard or as it would have been under a full-fledged gold standard, and we expressed the view that an over-issue of our rupees and notes was just as likely as an over-issue of inconvertible paper in other countries. This view is borne out by a parallelism between the increase in our currency and the movements of prices during the period under discussion. The following figures speak for themselves:—

Year	Coin	Total coin- age of rupees	Active note circulation on March 31	Clearings	Index number of prices
1893	Victoria 1893	7,87,30,310 ¹	19 crores	146 crores	129
1894	...	...	18 nearly	158 ..	122
1895	...	...	20 ..	176 ..	120
1896	...	...	20 ..	181 ..	131
1897	Victoria 1897	15,24,777 ²	20 ..	191 ..	153
1898	.. 1898	75,19,413 ²	19 ..	176 ..	125
1899	...	...	20 ..	203 ..	121

¹ Includes 590,000 coined for the Bikanir State.

² On account of Kashmir and Bhopal coinage.

Year	Coin	Total coin- age of rupees	Active note circulation on March 31	Clearings	Index number of prices
1900	Victoria 1900	11,81,39,499 ¹	22 crores nearly	212 crores	131
1901	„ 1901	10,91,35,961 ²	22 „	233 „	139
1902	„ 1901 but coined in 1902.	9,31,39,384 ³	22 „	232 „	128
	Edward VII 1903 coined in 1902.	25,000	...	...	...
1903	Edward VII 1903	10,23,47,506 ⁴	25 „	247 „	122
1904	„ 1904	16,02,78,908 ⁵	28 „	255 „	121 (contin- uous rise)
1905	„ 1905	12,74,60,106 ⁶	28 „	304 „	135
1906	„ 1906	26,37,50,433 ⁷	33 „	335 „	158
1907	„ 1907	25,22,49,816 ⁸	36 „	428 „	167
1908	„ 1908	3,09,32,498	32 „	410 „	179
1909	„ 1909	2,22,97,326 ⁹	33 „	412 „	160
1910	„ 1910	1,76,88,673	40 „	465 „	150
1911	„ 1910 coined in 1911.	5,82,386	...	...	...
	George V. 1911	94,43,049	40 „	516 „	155 (contin- uous rise)
1912	„ 1912	12,41,89,206 ¹⁰	44 „	589 „	174
1913	„ 1913	16,32,65,951 ¹¹	47 „	650 „	182
1914	„ „	4,83,70,151	50 „	538 „	187

Public attention was drawn to the significance of this parallelism as early as 1907 in an unsigned article entitled 'India's Present Monetary Condition', which appeared in the *Economic Journal* for March, 1907; and the late Mr. Gokhale pressed it upon the attention of Government in the Budget debate of

¹ Includes 2,09,02,414 coined for Indian States.

² Includes 1,90,43,904 coined for Indian States.

³ Includes 2,98,86,014 coined for Indian States.

⁴ Includes 11,66,451 coined for Indian States.

⁵ Includes 5,94,221 coined for Indian States.

⁶ Includes 3,28,000 coined for Indian States.

⁷ Includes 3,90,310 coined for Indian States and 167 lakhs coined from gold standard reserve silver.

⁸ Includes 94,766 coined for Indian States and 433 lakhs from gold standard reserve silver.

⁹ Includes 1,01,459 coined for Indian States.

¹⁰ Includes 16,56,250 coined for Indian States.

¹¹ Includes 12,78,441 coined for Indian States.

March, 1908, as the following extract from his speech on that occasion will show:—

‘It seems to me, my Lord, that the phenomenally heavy coinage of new rupees during the last few years by the Government has something to do with this general rise in prices . . . The stock of rupees in India before 1898 was estimated by Mr. Harrison, the expert, at 130 crores. During the last ten years, the Government has made a net addition to this stock of over 100 crores. It seems to me that such a sudden inflation of the country’s currency is bound to result in a general rise of prices. It may be said that, in view of the general expansion of trade during the last few years and of the increased industrial activity of the country, such augmentation was necessary. A reference to trade returns, however, does not support this view. During the twenty years preceding the closing of the mints, our exports of merchandise advanced from fifty-four crores to 106 crores, i. e. doubled themselves, and yet the average annual coinage only advanced from six crores to 8·3 crores during that time. Again from 1894 to 1905, the exports rose from 106 crores to 157 crores, but the annual average coinage for the five years ending 1904 was just the same as that for the eight years ending 1893, namely, 8·3 crores. It is therefore difficult to see why the average should have suddenly gone up from 8·3 crores to 20·7 crores during the last three years. What is probably happening is this. The rupees issued by the Government in response to the demands of trade go into the interior and spread themselves among those from whom purchases are made. But owing to various circumstances, they do not flow back quickly to centres of trade or to banks, and thus new rupees have to be obtained for transactions for which old rupees might have sufficed. Meanwhile, the melting back of rupees into silver having ceased, every issue becomes a net addition to the volume of the currency. If this analysis of the situation is correct, it suggests a grave problem, for it means that prices will tend to rise still further.’ Even Mr. Keynes, one of the ablest exponents of the gold exchange standard, recognized the significance of this parallelism between the rise of prices and the increase in our currency. In an article in the *Economic Journal* (March 1909) he showed by means of the following table that the percentage of increase in currency was very nearly the same as that of the rise in prices during the years 1903–07 :

Year	General index number of prices	Estimated total of the cur- rency on the 1st of April of each year
1903	100	100
1904	102	110
1905	112	115
1906	131	127
1907	140	136 (April 1)
		143 (December 31)

The Enquiry Committee demurred to the obvious conclusion to be drawn from this parallelism. They proved by means of a table showing the yearly and average net coinage of silver before and after the closing of the mints, 'that in spite of the heavy coinage of recent years, the average net coinage during the eighteen years subsequent to the closing of the mints was Rs. 5,66,00,000 and in the previous eighteen years Rs. 7,51,00,000'; and contended that, since the average annual coinage during the period 1892-93 to 1911-12 was much less than in the years 1874-75 to 1892-93, it could not have been the cause of the rise in prices during the period under enquiry.

But these figures were not really relevant to the issue. What mattered in this question was not the quantity of rupees minted but the amount of rupees put into *active circulation*. Prior to 1893, the value of the rupee was the same as the value of its silver content; and so a substantial part of the rupee coinage was used as bullion. A simple calculation would show the effect of correction on this account. Mr. F.C. Harrison estimated the volume of rupee circulation at 120 crores in 1892; and Sir Edward Baker put the loss by wastage at 2 per cent per annum. The average annual coinage previous to 1893 was about 7 crores, of which half used to be melted by the public, according to official estimates at one time. But later on, this proportion was admitted to have been an under-estimate, even by official experts like Mr. O'Connor, the Director-General of Statistics in 1898. When asked by the Fowler Committee to explain the continuous demand

for silver even after the closing of the mints, he said, 'It has been a subject of astonishment to us ever since the closing of the mints that there has been such a demand. Before the closing of the mints, practically all the silver imported, with the exception of about 4 per cent, passed into the mints and was coined. Then the assumption used to be that at least half of that remained in the currency as coined silver, and the other half was melted down. But it looks now, judging from those figures, as if that inference was not quite correct, and *that a very much larger proportion of the rupees that were coined must have been melted down* into ornaments.' When pressed to suggest if much of this amount was hoarded, he emphatically replied, 'No, not hoarded, judging from the imports of silver. I do not believe that any of these imports have got into hoard, I think they have been converted into ornaments, except so far as they went into the native mints.' It would not therefore be far wrong to put the amount which thus disappeared from circulation at 5 crores per annum. The annual addition to currency before the closing of the mints was thus only two crores on an average, an amount *just enough to make up the loss by wastage*. In other words, the rupee circulation was pretty steady prior to 1893. It is this fact more than any other that accounts for the comparative steadiness of prices before the closing of the mints.

Conditions, however, were different after 1893. Rupees once coined, remained coins; for it was unprofitable to melt them. They could be used only as currency; and so the entire amount of coinage influenced prices. There was another circumstance operating in the same direction. Prior to 1893, the value of the rupee was the same as the value of its silver content. The annual imports of silver (both bullion and coin) were small in comparison with the *total* stock of silver in the country; and so they could produce only an inappreciable fall in the value of silver. But after 1893 the purchasing power of the rupee depended mostly on the *quantity of currency* and the annual additions to the circulating medium were not quite so small, in comparison with the total amount of currency. They therefore produced a greater effect on rupee prices.

It is interesting to note in this connection the opinion of Mr. Lindsay, the real originator of the present system, on the nature of the rupee standard in India. He plainly told the Fowler

Committee, 'I look upon rupees under the present system as simply *inconvertible metallic notes* and they operate entirely according to the laws that govern an *inconvertible* paper currency. I think the laws that govern an inconvertible paper currency and the laws that govern an inconvertible *coin currency* are precisely the same.' (Q. 3742). The natural corollary follows, that the main cause of a rise of prices under an inconvertible coin currency is usually its excessive issue, or, to use a technical phrase, *over-issue*.

Much the same thing may be said about our note-circulation. Indian currency notes were convertible into rupees both before and after 1893; but the monetary changes of 1893 effected a revolution in the character of the rupee. Prior to 1893, it was a freely minted coin convertible into *bullion*; after 1893, it was a token coin not convertible freely into gold except on those rare occasions when Government sold Reverse Councils. The notes, being thus convertible only in an *inconvertible coin currency*, influenced prices much in the same way as inconvertible paper money does. We may here invite attention to the following remarks of Prof. Cannan in his book on *Money*:—

'It has not till lately been well understood, even by experts, that, when coin is not convertible into *free bullion*, convertible notes may be issued in quantities just as great as inconvertible notes and with exactly the same result. . . . A well-enforced denial of freedom to deal with coin would be sufficient by itself to allow over-issue to take place without the abolition of the convertibility of notes into coin. Recent experience has shown this to be perfectly possible. The British Treasury's one pound and ten-shilling currency notes have been convertible at the Bank of England into full-weight coin but are no longer convertible into free gold. Thus convertibility of note into coin is deprived of all its virtue when laws against melting and exportation of coin are present and effective. Convertible notes can then be issued without check just like inconvertible notes, and consequently can drag down the value of money below that of the bullion contents of the coin, and give rise to the same phenomenon, a rise of general prices, including the price of the bullion.'

8. We now come to the War period 1914-18. The rise of prices during these years was even more marked than in the

preceding twenty years, as the following table compiled by the Department of Statistics clearly shows :—

General Prices

		Unweighted index number	Weighted index number
Yearly average	1900-04 ...	100	100
Do.	1905-09 ...	120	122
Do.	1909-14 ...	127	130
Do.	1914 ...	138	143
Do.	1915 ...	143	139
Do.	1916 ...	173	142
Do.	1917 ...	184	142
Do.	1918 ...	211	165

During the same period, the currency in circulation was increasing by leaps and bounds. The total rupee, note and cheque currency, according to official estimates, rose from an average of 782 crores in the pre-war quinquennium 1910-14 to an average of 1,211 crores during the four years 1915-19. Expressing these by index numbers with 1900-04 as the basic period, we get 188 and 307 as the index numbers for the periods 1910-14, and 1915-18 respectively. The expansion of the circulating medium was really larger than this; for these figures do not include hundis or bills of exchange, which are in fact 'substitutes for money' and are capable of producing the same effect on prices as money. But not only did the volume of currency increase during this period but also its *velocity*; for, as Mr. Gubbay said in his statement before the Babington Smith Committee, 'nothing is more remarkable during the past few years than the way in which the unprecedentedly large Government disbursements have returned to the banks in the principal money-markets, there to be caught up again in the wheel of credit'. These facts point unmistakably to a considerable degree of inflation in the country, for production in India increased only 30 per cent during the period 1913-19. Even the official estimates agree that the growth in circulation had 'outstripped the growth in business to a marked extent.'¹

¹ Shirras, *Indian Finance and Currency*, p. 131.

How close the correspondence between the rise of prices and increase of circulation has been is shown by the following table based upon the rough estimates of Professor Jevons :—¹

Year	Total circulation. Rupees, notes & Bank deposits. Rs. in Crores	Official index number of prices (unweighted)	Index of circulation with 1912 as the basic year	Index number of prices with 1912 as the basic year
1912	345	137	100	100
1913	353	143	102	104
1914	342	147	99	107
1915	362	152	105	111
1916	411	184	119	134
1917	499	196	145	143
1918	570	225	165	164
1919	675	276	195	201
1920	647	281	187	205

9. As usual the official apologists attempt to absolve Government from all blame in the matter by attributing the rise of prices to causes beyond Government control. This undeniable expansion of currency is said to have been ' the result of increased demand on the part of the trade and the public for currency, owing to high prices of Indian produce resulting from increased demand for it from abroad ' ; and the rise of prices is represented to have been the *inevitable consequence* of the general rise of prices *abroad*. There is no doubt an element of truth in this view. Many of our exports such as wheat, cotton, jute, hides, tea, etc., have a world-wide market ; so also some of our imports, e.g. cotton goods. The prices of these are determined by the supply and demand for them in all the countries of the world combined ; and, if their world prices rise, their prices in India must also move in an upward direction. But this fact alone cannot explain a *general* rise of prices of almost *all* articles *at the same time* ; that can only happen when the currency of the country has expanded faster than its total business. This line of argument, moreover, seems to confound cause with effect. Is inflation the cause of high prices or high prices the cause of inflation ? If the theory outlined in chapter ii is correct—and no official apologist has ever expressly repudiated it—there is no

¹ See Jevons, *Future of Exchange*, pp. 436-46 and the *Report of the Controller of Currency*, 1921-22, p. 37.

doubt that prices cannot rise without a *previous* creation of artificial purchasing power.

In justice, however, to the official views on this subject, it must be admitted that Government had no option but to flood the country with currency, if it was to adhere to the basic principles of our pre-war currency system and continue its restrictions on the imports of specie into India. As shown in chapter iv, exchange between two countries depends essentially upon the relative purchasing power of their currencies. Had Government abstained from issuing more currency in the war period, the value of the *sterling* in terms of rupees would have *fallen* as soon as sterling prices at the English ports rose. Had this been permitted, the purchasing power of the rupee would have been altogether independent of any inflation or rise of prices in England or elsewhere. But Government was wedded to the principle of *stabilizing* the rupee-sterling exchange; and so Council Bills were sold freely at fixed rates, and the country was surfeited with currency. Prices rose, and the demand for currency continued unabated owing to the constant inflation abroad. The currency system of India thus involved Government in a vicious circle. It was in fact the most important cause of the rise of prices; and experts like Sir David Barbour practically admitted the justice of this charge, as the following extract from his evidence before the Babington Smith Committee will show :—

‘The fundamental principle on which the gold standard in India was based was that silver rupees would only be issued in India at the rate of fifteen rupees for the quantity of gold contained in a sovereign.

‘As a matter of convenience, however, it was arranged that, instead of presenting gold at the Indian mints, persons wishing to obtain rupees might purchase drafts on India from the India Office at an appropriate rate of exchange.

‘The procedure was quite sound so long as “the pound sterling” was freely exchangeable for gold and there was a free market in gold. These conditions were not fulfilled in recent years, and we have been *trying to maintain the old rate of exchange*, not between the rupee and gold, but *between the rupee and the “pound sterling”*, when the “pound sterling” has been *practically divorced from gold*.

‘The danger of the procedure would be understood more clearly if we considered what would have happened if the rupee had been linked to gold through the medium of the German mark, at the rate of twenty marks to fifteen rupees, and if an attempt had been made to maintain this rate during the last five years.

‘The rupee would simply have been *enormously depreciated in purchasing power*, there would have been a considerable rise of prices in India, and it would have been impossible to find currency for India except by excessive issues of inconvertible notes. *Similar results, fortunately in a much less degree, have followed the attempt* to maintain the old rate of exchange between the rupee and the “pound sterling” instead of between the rupee and gold.’ We may here add that, while Sir David Barbour was right in his diagnosis of the disease, the remedy he suggested was not a permanent solution of the problem of inflation.

10. This inflation continued even after the Armistice, and we may therefore mention here some of the various ways in which it was actually brought about. In the first place, Government financed its own expenditure and also that on behalf of the Home Government, by issuing notes without any metallic backing at all. As stated in chapter iii, the legal limit of the invested portion of the Paper Currency Reserve was raised several times, till at the end of 1919 it stood at 120 crores, of which only twenty crores could be invested in securities of the Government of India. The issue of notes of such low denominations as Rs. 2½ and Re. 1 further expanded the note issue; and the evil was aggravated by the withdrawal of facilities for encashing notes. Secondly, Government issued large quantities of rupees largely to meet the heavy sale of Council Bills due to unprecedentedly favourable trade balances during the period, without keeping the profits from this coinage in the form of gold. On November 30, 1919, the Gold Standard Reserve was held almost entirely in securities. This had an effect similar to that of the issue of notes without metallic backing; the difference between the two was in fact one of degree and not of kind. Thirdly, the issue of loans by Government on an unprecedented scale led to inflation. The large amount of Government securities enlarged the basis of bank credits, and many who subscribed to the War Loan stock took it to their banks, borrowed nine-tenths of its value on the strength of it, and often with these

borrowed funds purchased more stock and re-borrowed from the banks on its security. The increase of these loans thus led to increase of deposits and creation of more bank money. Government also issued short term bills (mostly for three, six, or nine months), called Treasury Bills, in order to finance their deficits. Quite a large proportion of these were purchased by banks; and, being re-payable at an early date, they were regarded by the banks as a potential source of cash, justifying them in keeping a smaller proportion of 'cash reserves' to deposits than they had deemed advisable before the war. So long as these Treasury Bills were not repaid, the volume of bank money thus tended to be abnormally large as compared with the amount of real cash, and to maintain a higher level of prices. We may then conclude that during the period following the war, the volume of money in the principal money-markets of India had increased enormously owing to the enormous disbursements by Government, the expansion of currency note circulation, and the creation of credit.

11. During the period 1920-22 there was an extensive fall of prices in America, England, and many other countries, but not in India. As the reader will see for himself, there is a striking contrast between the following table taken from the *Economist*, dated June 17, 1922 and that given on page 142 of this chapter :—

Date	Cereals and meat	Other food products (tea, sugar etc.)	Textiles	Minerals	Miscell. rubber, timber	Oil	Total percentage change
Basis (Aug. 1901-05)	500	300	500	400	500	2200	100·0
End July, 1914	579	352	616½	464½	553	2565	116·6
„ Nov. 1918	1289	782½	1848	903	1389½	6212	282·6
„ Mar. 1920	1508	914	2974½	1246	1709½	8352	379·6
„ Dec. 1921	921½	636	1106	762	931½	4357	198·0
„ Jan. 1922	907½	654	1106½	730	925½	4284	194·7
„ Feb. „	948	640½	1037½	696½	936½	4259	193·6
„ Mar. „	980	687	1038	700	892	4297	195·3
„ Apr. „	1008½	667	1010	709½	890	4285	194·8
„ May „	1040½	657	1079	710½	885	4372	198·7
„ June „	1000½	676½	1135	690	887	4389	199·5
„ July „	994½	669	1120	712½	900	4396	199·8

During the two years, June 1920 to June 1922, the contraction of the English currency notes amounted to £60,000,000.

Most of the other civilized countries adopted a similar policy and showed a similar fall in their price-levels. Comparing the fall of prices in different countries from their maximum monthly price-levels in 1920, we find, according to the figures quoted by the *Statist*, that by September, 1922, the drop in England was from 313 to 151, in the United States from 264 to 164, in France from 588 to 329, in Italy from 670 to 582, and in Japan from 322 to 195, as against a fall in Bombay from 224 only to 181. A memorandum prepared by Mr. Findlay Shirras and published recently shows that

(1) The highest level of wholesale prices in India was reached in July 1919, and the lowest in December 1922, the extent of the fall from the highest level being 27 per cent ;

(2) The rise in Great Britain was greatest in May 1920, and the lowest point reached was in September 1922, the extent of the fall being 54 per cent ;

(3) In the United States the highest point reached was in May 1920, and the lowest in June 1921, the fall in this case being nearly 47 per cent.

The reason for this contrast is easy to seek. Here in India Government has no satisfactory method of withdrawing the currency from circulation ; even the clumsy methods available have not been utilized to the full. A policy of deflation by the sale of Reverse Council Bills was begun in 1920, but was soon given up (see chapter viii). A series of financial deficits since 1920 seriously crippled the power of Government to do anything substantial in the matter, for Government financed these deficits by the issue of fiduciary currency notes, by incurring floating debt in the shape of Treasury Bills, and by appropriating large sums from the proceeds of their regular annual borrowings. The general depression in trade during 1920-22 tended to contract circulation to the extent of about sixty-three crores,¹ but any courageous policy of deflation appeared to be almost out of the question so long as Government lived on credit and was anxious to avoid unpopularity with the commercial classes, who dislike nothing so much as a stringency in the money-market. A Government that wishes to regulate artificially a currency system on scientific principles must be

¹ Jevons' estimate.

prepared to face the agitation of an interested class, coolly and resolutely. If it finds that it cannot afford to withstand pressure, it must give up all control over currency arrangements and confine itself only to those functions which the experience of democratic countries shows that it can adequately discharge.

CHAPTER XIII

MAIN DEFECTS AND SUGGESTED REMEDIES

1. . The history of the Indian Currency System as outlined in the preceding chapters shows unmistakably the influence of one governing idea in all the various stages of its growth. Stability of exchange was the supreme consideration with Government; and everything else was subordinated to that one end. The Chamberlain Commission considered that the 'cardinal feature' of the Indian system was 'the absolute security for the convertibility into sterling of so much of the internal currency as may, at any moment, be required for the settlement of India's external obligations.'¹ Almost all the official witnesses before the Babington Smith Committee held the same view : Sir Lionel Abraham was interested only in the 'practical solution of three main problems', of which the very first was 'one relating to the rate of exchange'; and Mr. Gubbay, in representing the views of the Government of India, had no hesitation in saying, 'In the Government of India's statement, the problem as it appears to them is the consideration of the means of securing the greatest practical stability of the rupee in terms of the sovereign.' At almost every stage in the evolution of our currency system, the difficulties of Government have loomed large; and Government all along has looked at the problem more from the point of view of an interested party than that of a custodian of public interests.

It is refreshing therefore to note a return to common sense in the report of the Babington Smith Committee. They rightly pointed out that 'exchange stability is an important facility rather than an essential condition. There are many instances, including that of India herself before the closing of the mints, which show that trade had flourished and can flourish with a fluctuating exchange. The conditions are somewhat more speculative, but the difficulties that may arise are not insuperable, and the banks are not slow to supply machinery that enables

¹ Para. 76, p. 20 of the Report.

the merchant to cover his risks'.¹ Pronouncements like these are a complete vindication of those witnesses who in their evidence before the Herschell and Fowler Committees opposed the policy of Government on the ground that it was 'a mistake to link the maintenance of the standard of value of any country with the incidental and varying circumstances of exchange.'²

In spite of this correct estimate of the value of exchange stability, it is curious to note that the Committee did not completely shake off the influence of the old idea. They recommended the linking of the rupee to 2s. *gold* in the hope that, when sterling returned to its pre-war parity with gold, *the rupee-sterling exchange would again be stabilized*. Grant the possibility, would this mean stabilization of the exchanges *with 80 per cent of the countries with which India trades?* If not, what becomes of the argument against the silver standard that was made so much of by the Herschell Committee?

The reader must not conclude from this that exchange fluctuations at the present time are not a great evil. Undoubtedly they are, being largely responsible for a serious dislocation in international trade. But this instability of foreign exchanges is a symptom of a disease rather than the disease itself. The real diseases are political insecurity, chaotic finance, and currency inflation in the greater part of the world. Attend to these maladies, and exchanges will take care of themselves. Were the currencies of the world stabilized to-day, exchange fluctuations would be reduced to such dimensions as would induce banks 'to supply the machinery which would enable the merchant to cover his risks.'

The truth is, that stability of exchange is an *international* and not a national problem. The problem of exchange stabilization is world-wide in character, demanding for its solution concerted international action. It is not in the power of any country to stabilize its exchange with other countries, when the commodity values of foreign currencies are constantly changing because of deflation in some countries and inflation in others.

As Prof. Cassel put it, 'a stabilization of the world's exchange conditions cannot, as apparently people sometimes try to imagine, be attained by the separate countries now at once

¹ Para. 34.

² Cf. Robert Barclay

attempting to stabilize their exchange rates. The stabilization of the internal values of the currencies must come first. In that sphere each country can have any aim in view it likes. But it will be unable to control the exchange rate as against another country so long as that other country has not stabilized the internal value of its currency. If the re-establishment of a certain definite exchange rate is deemed desirable, this can only be effected by some sort of international co-operation.¹

But did not the Indian Government stabilize exchange during the period 1900-13? Yes, it did; but the circumstances were specially favourable then. The balance of account was continuously in favour of India; India was continuously borrowing abroad; and many countries were on a gold basis. All that the Government did in these circumstances was to prevent a *rise* in the external value of the rupee by increasing the supply of rupees. The real test came when the balance of account turned against India, temporarily in 1907 and for a considerable period in 1920 and 1921. On the first occasion, exchange did go down to 1s. 3 $\frac{2}{3}$ $\frac{3}{4}$ d.; and on the second occasion Government found itself powerless, after dissipating a considerable portion of India's gold resources in a fruitless effort to control exchange. The course of events has fulfilled almost to the letter the prophecy of Sir Robert Giffen. Asked what he thought of Mr. Lindsay's scheme, he said to the Fowler Committee, 'No doubt these schemes, in *fair weather* times, and for a certain time might work, but I do not think they can be depended upon *permanently*.' The Indian currency has proved to be only a fair weather currency.

It is necessary to realize clearly what the full implications of our currency system are. Government cannot, without international action, stabilize our exchange with other countries. All that it can do is to prevent a *rise* in the *sterling* value of the rupee by flooding the country with currency, and so raise the price-level at the Indian ports to the level of prices at the English ports. It has no adequate machinery to withdraw currency with, when there is a *fall* of prices at the English ports; it can only sit quiet, and allow the natural growth of business to produce a corresponding fall of prices. In other words, the Indian standard of value is at

¹ *Money and Foreign Exchanges after 1914*, p. 272.

the mercy of currency changes in England. It is a *dependent* standard, and a clumsy one at that.

As for exchange stability, it is really useless without international action. Stable exchanges between any two countries, or even a group of countries (which is all that is possible), cannot bind up a stable international commerce while exchange on other important countries continues to fluctuate, for the markets of the former would be subject to constant exchange-dumping on the part of the inflationist countries. As the *Statist* put it, 'stabilization must be general or it is useless.'

The only wise course in the present circumstances is for each country to take care of its own standard of value and put it on a satisfactory footing, in order to secure public confidence in the stability of its purchasing power.

2. The second leading characteristic of the Indian Currency System is the peculiar part that the Government plays in it. In pre-war England, France, or Germany, the currency arrangements were totally independent of the Government; and it was generally recognized that Governments were not in a position to judge of the currency requirements of a country in particular years, or in particular seasons of the year, so well as banking institutions in intimate touch with trade. Even financial institutions were not fully entrusted with this task. The possibility of their miscalculating in this matter was taken into account, and was safeguarded against by the provision of an *automatic* process of expanding and curtailing the currency. Here in India, Government has been attempting too much: it has taken upon itself the whole task of providing the necessary supply of currency, and adjusting it to the varying needs of different occasions—a task not completely entrusted even to a banking institution in any other great country of the world—a task beyond its ability and one that exposes it to undesirable pressure. The expansion of currency benefits some, but injures others; some people therefore desire expansion of currency, others curtailment. A Government that takes upon itself the duty of deciding between these conflicting interests puts itself in a very difficult position, which it is very desirable for it to avoid if it can.¹ In fact, since the closing of

¹ Sir John Lubbock. Q. 11049. Fowler Committee.

the mints, the Indian Currency System has been managed at the whim of the latest official sent out from England. 'One man could come along and stuff the currency, the next would starve it—there has been no plan at all, nor is there to-day, but always some fresh experiment advised—a gold mint, prohibitive duties on silver bullion—anything or everything.'¹

A Government in a transitional stage is specially susceptible to pressure from interested quarters. The burden of high prices may be an intolerable one for the country, and yet, if Government attempts to carry out a policy of deflation and consequent monetary stringency, it may produce great dissatisfaction in the local money-markets, and set in motion the forces of a huge agitation against itself. No Government can afford to flout the opinion of commercial interests, much less the Government of India in these days, when determined assaults are being made on its reputation as a custodian of Indian interests, and when one has only to raise the cry of 'Indian interests in danger' to have behind one the entire support of the country. Its undeniable inconsistencies have made even thinking people doubt its *bona fides* in currency matters. For instance, Government had no hesitation in endorsing Mr. Datta's view that high prices were good for India as a whole when it was considered necessary to justify the continuance of a particular policy; but, when the currency system of the country had to be changed in order to obtain relief from certain embarrassments, it threw overboard all its old dicta about the beneficent effects of high prices, and asked the wondering public to approve of a high rate of exchange, because of the tendency of such a rate to produce a *beneficent fall of prices*. Such complete changes of front are likely to shake public confidence in the *bona fides* of the Government; and the only wise policy for a Government in such a position is not to take upon itself the duty of deciding between conflicting interests in currency matters.

The Government of India further attempts to regulate exchange by methods that involve 'a large and continuous amount of management, which affects the sales of Councils,

¹ Moreton Frewen's Evidence before the Chamberlain Commission, Q. 9519.

which affects the purchase of silver, which affects the movements of bullion, in so many respects that the element of management must be conspicuous until such times as additions to the currency are in the medium in which the balance of trade is liquidated.¹ It is often said in defence of this element of management that of no country was the exchange left entirely unregulated, even in pre-war days. But there is no real analogy between the control exercised in pre-war England by the Bank of England and the task undertaken by the Government of India in respect of Indian exchange. It is one thing to prevent exchange from falling below gold points and regulating the outflow of gold in gold standard countries; it is quite another thing to regulate the exchange of a country based on inconvertible paper or coin currency. In the one case, the par of exchange is settled by natural causes; in the other case, the regulating authority attempts to fix artificially the very parity of exchange. Government control in the second case is not only futile but positively mischievous; and that is why the Brussels International Conference condemned Government interference in exchange.

But, apart from this general objection, there are special objections to Government interference in exchange in a dependent country like India. Nothing is more calculated to arouse ill will against England than the widely prevalent idea that the currency policy of Government is determined more by the interests of the London money-market than by the real needs of India. And unfortunately this idea is not entirely baseless. It is wrong, for instance, that the balances of India should be administered in London, at the India Office, by gentlemen who are bankers in that city, because public interests and their interests as bankers are bound to be occasionally in conflict.² There is no justification whatever for the common practice of the Secretary of State to withdraw colossal sums of State money (for which he has not the slightest use) from India to London, only to find himself obliged to lend money to private borrowers in London in such profusion that—to quote Lord Swaythling's words in the House of Lords on

¹ Sir Stanley Reed before the Chamberlain Commission, Q. 10151.

² See Mr. F. C. Harrison's evidence before the Chamberlain Commission, Q. 10193.

November 14, 1912—‘ It was well known that so large were the amounts lent at one time this year by the India Council that there was a scarcity of the securities (which the India Office demanded against loans) among the approved borrowers, and the India Council therefore lent large sums to clearing banks at lower rates than they could have lent them to the approved borrowers, supposing that there had been more securities available.’ Nor is there any adequate reason why the Secretary of State should ‘ play exchange banker for the benefit of either European buyers who desire to lay down funds economically in India for the easy purchase of Indian products, or certain sections of the export trading community in India who want to sell their bills to the local exchange banks at the lowest and the most favourable rates for themselves.’ ‘ There is much in this business that lends itself to condemnation and justifies the verdict of a retired Indian official : ‘ Where a country is an appendage of another more powerful one, the latter usually takes control. In canine language, it wags its own tail, or, to adopt a more appropriate metaphor, the big brother takes charge of the little one. This course has certain advantages in the matter of centering financial management, and is certainly to the taste of the elder brother. But a real danger exists, that the younger goes to the wall and is left to pick up the scraps of his senior’s well-furnished table ’.’¹

3. But by far the worst defect of our inconvertible rupee is its failure to satisfy the most essential requisite of a sound currency, namely, stability of purchasing power. It has failed in this respect to a much greater extent than the old freely-minted rupee did. We have already discussed at length this aspect of the question, and pointed out the connection between high prices and the Indian Currency System. It is true that the ordinary man in the street has not even heard the phrase ‘ Gold exchange standard ’ ; but he does know that his rupee does not purchase the same number of commodities as before. He does not know the reason why, but he has a vague feeling that Government is playing upon him some strange trick. This is a very serious matter for a Government, for, to use the words of Professor Nicholson, ‘ it is a bad thing for a

¹ F. C. Harrison in the *Economic Journal*, September 1917. .

country when the masses of the people begin to feel that something is wrong with the currency.'

4. The preceding review of the main defects of our currency system naturally raises the question of reform—a question by no means peculiar to this country. Everywhere, the currency reformer is dissatisfied not only with the conditions as they exist to-day but even with the conditions that prevailed in pre-war days, for in no country has the monetary unit ever been perfectly stable in its purchasing power. For instance, one of the best American economists spoke contemptuously of the American standard of value even in pre-war days, and held it responsible for a 'colossal social wrong'. 'It is a great pickpocket' said he, 'robbing first one set of people, and then another, to the tune of millions of dollars a year, confounding business calculations and convulsing trade, stirring up discontent, fanning the flames of class hatred, perverting politics.'

But is stability of purchasing power the highest ideal to be aimed at in devising a standard of value? It is true that, if prices fluctuate, contracts to pay money at a future date are affected to the prejudice either of the creditor or the debtor, for the obligation, which ought to remain constant, varies in reality with the greater or less purchasing power of the standard. But it may well be questioned 'whether the strict idea would not require that the constancy of obligation aimed at should be to render the same *labour* rather than to transfer the same commodities, so that the sacrifice of toil in repaying an obligation should be the same as that which was involved in its creation'.¹

But, apart from this abstract criticism, there are practical difficulties in the attainment of this ideal. All commodities and services do not change their relation to the standard simultaneously and *pari passu*, for the change may arise from the circumstances operating under the different commodities themselves. And, as was remarked by the Gold and Silver Commission, 'even if it were practicable to adjust the standard in correspondence with an increase in the supply of any class of commodities or services, the result would be to alter its relation to things not comprised within that class, the supply of which either had not increased—or not to the same extent—and thus to bring about the very evil that it was sought to remedy.' A perfectly stable

¹ Gold and Silver Commission.

standard of value is thus unattainable. As Sir David Barbour put it, 'There never was, and never can be, such a thing as a fixed and invariable standard of value which will measure any quantity of wealth in the same way and with the same accuracy as a yard-measure will measure length.'

Nevertheless, anything that is likely to give the standard a greater stability than it has at present would be distinctly a change for the better. It may not be possible to give it a uniform purchasing power for *all* classes of purchasers; but, even if it has uniform value *on the whole* and for the *average* purchaser, it will be a distinct improvement on the present state of affairs. This is the main idea behind the various schemes for stabilizing the *general level of prices*.

5. The simplest of these is the issue of inconvertible paper, in quantities so proportioned to increase of business, that the total volume of currency multiplied by its average velocity of circulation would bear the same relation to the total business at one time or at any other time. But its chief drawback is the temptation it places in the hands of Government to over-issue the currency, and 'sad experience teaches that irredeemable paper, while theoretically capable of steadying prices, is apt in practice to be so manipulated as to produce instability.'

The least objectionable of these schemes is the one associated with the name of Dr. Fisher, though he was by no means the sole author of it. It was intended to stabilize the American dollar; but it is equally applicable to the problem of stabilizing the rupee. It abandons the practice of adopting a particular commodity as the unit of value, and substitutes for it a 'token' or 'certificate', representing a definite series of quantities of given commodities and constituting what may be called 'a composite unit'. It proposes to vary the weight of gold in the dollar, or rather behind the dollar, and shifts it up or down according as the purchasing power of the dollar (as measured by the index number of prices) goes down or up. Its object is to increase the weight of the dollar just fast enough to compensate for the loss in the purchasing power of each grain of gold, in other words, to have a fully 'compensated dollar'. It thus aims at substituting a dollar of fixed purchasing power but varying

¹ Fisher's *Purchasing Power of Money*.

weight, for a dollar of fixed weight but varying purchasing power. Dr. Fisher's fully developed plan contemplates an international system and attempts to combine together the following three separate functions : (1) the function of maintaining an exchange par with a selected country ; (2) the function of regulating the currency in that selected country by a bureau of currency regulation through a purchase or sale of gold at a varying official price ; (3) the function of fixing this official price of gold according to the index number prices ascertained by an international statistical office. How the plan is likely to work, is explained by him in the following passage : ' For instance, if, a year after the system was started, it were found by the statistical office that prices have risen 1 per cent, this office would, in order to neutralize the rise, issue an official declaration to the bureau of currency, fixing the official price of gold at substantially one per cent lower than the ruling market price. At this cheap price the public will buy gold bullion of the Government and surrender currency in return. Therefore the currency will be contracted and general prices will fall until no more gold is called for, or until there is declared a new official gold price. Should the next official gold price be set above the market price, the Government would become a buyer of gold and would thus re-issue some of the currency previously called in, or if need be, issue new currency.'

The scheme outlined above is free from the danger of official manipulation of currency. 'The official who will regulate the currency will buy and sell gold at the pleasure of the public at specific prices fixed by others. 'He would have', as Dr. Fisher explains, 'no more choice than a broker who is ordered to buy or sell at prices specified by his customers'. Nor is there much danger of abuse or fraud in the statistical office, as its work will be based on published market prices and done in the light of day.

Dr. Fisher further claims that his plan is free from the danger of inflationist legislation. 'No individual nation could inflate the currency without withdrawing from the international arrangement and isolating itself accordingly, while it is quite inconceivable that all the civilized nations of the world should voluntarily and simultaneously commit the folly of inflationist legislation.'

¹ Fisher's *Purchasing Power of Money*.

Although Dr. Fisher contemplates the regulation of the world's currencies by buying and selling gold, *silver* or any other commodity could be used instead. He himself deprecates the spectacle of India 'clinging to the skirts, as it were, of the gold standard countries and following that erratic standard wherever it may lead them, although it is within her power by exactly the same machinery to keep her course steady.' The Indian Government is already in close touch with both the exchange and the bullion market, and the Indian Department of Statistics and the Labour Office in Bombay have taken seriously to the work of compiling index numbers of prices. To all appearances, then, conditions in India seem quite favourable to the adoption of Dr. Fisher's plan.

It is no use, however, underestimating the difficulties of putting into force a scheme of this kind. It is best to be cautious in matters of this sort, for there are no cases on record in which any standard has attained stability of purchasing power under changing conditions. International co-operation in currency matters has at no time presented greater difficulties than at the present moment, when all the civilized countries of the world have actually committed what to Dr. Fisher appeared inconceivable some years ago, the folly of inflationist legislation voluntarily and simultaneously. Nor is the practical difficulty of measuring the purchasing power of the unit or of working a currency system merely by reference to an index number of prices a negligible one. 'Any available index number is bound to be affected by the price-variations in particular commodities arising from non-monetary causes, such as harvest conditions, new inventions, discovery or development of new sources of supply, or exhaustion of those that exist. A blind adherence to the index may hide a real departure from the path of stabilization. And, what is almost more fundamental, a change in the monetary supply may manifest itself at first, not in a change of prices at all, but in a change in the volume of purchases; it may have made material progress before the index number is affected. Stabilization cannot be effected by any hard and fast rules. The central banks must exercise discretion, they must be ready to detect or forestall any monetary disturbance even before it has affected prices. The policy can only be perfect by long experience.'¹

¹ Hawtrey's *Monetary Reconstruction*.

Moreover, changes in the weight of the standard coin will have to be limited to very small amounts, say to 2 per cent or $2\frac{1}{4}$ per cent per annum, if the treasury is not to be exposed to the activity of speculators in bullion. At any rate, the scheme can work only after prices have gone down to something like a stable normal level, and ought not to be adopted except by international agreement, in view of the disturbance that it would involve in the international exchanges.

But the greatest difficulty in the way is the distrust of the public in all schemes that are too scientific to be easily understood by the lay mind. And trust and confidence are the very essence of the matter in currency problems. Until the public is educated in the matter, Dr. Fisher's plan must wait.

6. Shall we then revert back to the old silver standard, free and automatic? There is nothing absurd in this idea. The case against the silver standard, as already shown in a previous chapter, was hardly strong enough to justify the closing of the mints. Silver was much steadier in value in relation to commodities than gold was or has been; and silver, according to the high authority of Prof. Marshall, is likely to be a good metal for currency purposes in the future 'when the East—or, since we must include Africa and South America—when the non-Western world has got into the habit of using currency for the ordinary transactions of life, and has not got to the stage at which gold would be likely to be used very frequently.'¹ But such a reversion to the past is bound to produce a temporary yet nevertheless a serious shock; and in currency matters such shocks should be avoided as far as possible. As Prof. Marshall said to the Fowler Committee, 'the function of the legislator as regards currency is to do as little as possible. Almost any currency of which the position is certain will do its work fairly well. Frequent changes in its basis disturb expectation, upset reasonable calculations, and infuse a spirit of unrest into business. They may all aim at increased certainty, but their effect on the balance must be increased uncertainty. They resemble the frequent wakings of a patient in order to administer sleeping draughts.'

7. The only alternative left would seem to be an effective, automatic gold standard. The form most in favour with the

¹ See Prof. Marshall's evidence before the Fowler Committee.

advocates of a gold standard is indicated by the phrase 'a gold standard with gold currency in active circulation'. We have discussed this matter at great length in chapter xi, and shown our reasons for the view that gold is not a suitable medium of exchange in India. But, apart from this aspect of the matter, the proposal appears to be most inopportune at the present time. Prof. Cassel has by his recent writings abundantly warned the world that, while the production of gold is at present insufficient for the necessary formal increase in the world's stock of gold, the demand for gold as a material for articles of luxury has substantially increased and threatens to absorb a large part of the diminished annual production of gold. In these circumstances, it is necessary to keep down the world's monetary demand for gold, if we are to avoid a heavy fall of prices all over the world, which 'would kill all enterprise and impede that reconstruction of the world which is just now so very urgent',¹ even in the interests of India herself.

Nor is the question of cost a matter to be brushed aside lightly in so poor a country as India. There is no adequate reason why poor nations should allow a large part of their resources to be spent in providing themselves with so costly a medium of exchange as a gold currency, if something cheaper can serve all the purposes that it would do. The exhaustion of the European nations during the war has tended to move the best thought of the world in currency matters along this line of thought. As a distinguished foreign economist said, 'the war has now made the population accustomed to the use of cheap fiduciary methods for this purpose. Certainly nobody will expect gold to take its old place again. The exhausted nations can utilize their enfeebled energy more usefully than by buying back the gold from abroad in exchange for the fruits of their exertions, in order to permit themselves the luxury of paying their little purchases in the home trade therewith. In Germany authoritative voices are being raised, that plead for the regulation of its currency system *apart from gold* altogether.'² It seems as if the world were coming round to Ricardo's view that 'the introduction of the precious metals for the purpose of money may with truth be considered one of the most important steps

¹ See in this connection Layton's *Introduction to the Study of Prices*, p. 101.

² C. A. Verrigin Stuart in the *Economic Journal*, xxix, March, 1919.

towards the improvement of commerce and the arts of civilized life ; but it is not less true that, with the advancement of knowledge and science, we discover that it would be another improvement to banish them again from the employment to which, during a less enlightened period, they had been so advantageously applied.' It is rather unfortunate that these recent tendencies in economic thought on currency problems find practically no response in India, and that the old cry for a gold mint and gold currency in active circulation should continue to exercise its spell over popular politicians even at a time when the world is seeking a cheaper substitute for its currency requirements.

It is interesting to note in this connection that some of the leading currency experts of the world are talking at the present moment of the feasibility of a gold-exchange standard in the world as a whole, and that the International Conference at Genoa actually passed a resolution in favour of 'some means of economizing the use of gold by maintaining reserves in the form of foreign balances, such for example as the gold-exchange system or international gold-exchange system.' The general object of this scheme of an international gold-exchange system is 'that the currency of each participating country, instead of being convertible into gold, may be convertible at par into the *currencies* of the others.' To secure this, the participating countries will hold reserves of 'approved assets' in one another's currencies, and will undertake to buy and sell such assets freely for their own currencies. Further, with the view to base the scheme on a gold standard, it is proposed that 'certain of the participating countries will establish a free market in gold and thus become gold centres.' In principle, then, they have much in common with Dr. Fisher's plan. Should any scheme on these lines actually materialize, it will be foolish for India to hold aloof merely because of a sentimental desire for a visible gold currency.

It is worth while, at this stage, to mark the differences between the pre-war Indian currency system and these new schemes of an international gold-exchange system. In the first place there is no talk of any attempt to prevent a *risc* in the exchange of any country participating in the system. As one of its advocates explains, 'the Bank can hardly be obliged to take measures against a *risc*, the sign of depreciation of the foreign value, although it will quite naturally contribute a little to the restora-

tion of a rising exchange as a prominent purchaser in the market. Even in countries with a metallic currency system, neither Government nor the Board of the Bank have ever been either legally or even morally obliged to guarantee industrial life against possible depreciation of foreign values'.¹ The *only instance* of such a guarantee is the voluntary practice of the Secretary of State of preventing a *rise* in the sterling value of the rupee by selling Council Drafts at fixed rates in *unlimited amounts*. Secondly, these new schemes all insist on a *direct limitation* on the quantity of legal tender money within the country. Thirdly, the advocates of the proposed system generally recognize that the currency policy is ultimately credit policy, and that the *co-operation of the central banks* of the participating countries is an essential condition in the problem. Lastly, these schemes aim at regulating credit 'not only with a view to maintaining the currencies at par with one another, but also with a view to preventing undue fluctuations in the *purchasing power of gold*' (*vide* resolution No. 11, Genoa Conference). In other words, these schemes imply: (a) international co-operation; (b) a policy of stabilizing prices; and (c) a policy of economizing the use of gold in internal circulation.

If the Indian system is modified along these lines, almost all the objections against it disappear. But the crucial questions are: Is it possible to have a binding international agreement in these matters? Is it practicable to regulate, not only the legal tender currency, but also the market rate of discount or the rate of interest by the use of an index number of prices? Is the public sufficiently educated to have confidence in such a reform? There is nothing inherently impossible in the scheme, but the practical difficulties seem almost as insurmountable as in Dr. Fisher's plan.

8. We must therefore be content with something less satisfactory but more feasible. The main object to be aimed at should be to ensure the automatic expansion and contraction of our currency. For this it is enough to have a 'convertible rupee', convertible not in gold coins, but *gold bullion* only. Convertibility is the best safety-valve for redundancy of currency; it provides the easiest automatic danger-signal to Government when it is inflating

¹ C. A. Verrigin Stuart in the *Economic Journal*, March, 1919.

the currency. A system of convertibility will not need for its success a large quantity of gold *if the British sovereign ceases to be legal tender*. For, if the rupees in circulation are diminished and *not replaced by gold coins*, the value of the rupee will rise quickly to the point where it will cease to be profitable to exchange rupees for gold.¹ The rupee will still remain king in India; the natural demand for it will not decrease in any way. It is no doubt possible that in times of war or severe famine convertibility may involve Government in serious risks; but, if the Bank of France has had sometimes to suspend cash payments or the British Government to suspend the Bank Charter Act, there is no harm if a similar course is left open to the Indian Government in exceptionally grave emergencies. Such exceptional cases, as was pointed out by Mr. Farrer in his evidence before the Fowler Committee, are not made the basis of currency systems. 'We look to the *ordinary* state of things.' Looking at the problem from this point of view, India's case seems to be a specially favourable one. 'She has a great and elastic power of producing saleable exports; she imports, on the balance, a large quantity of the precious metals, which she retains with great tenacity; and she recovers very quickly from great depressions.'² It is again true that the largest possible reserve of gold will prove insufficient if all the rupees in India, or, for the matter of that, even all the rupees except those absolutely required for purposes of circulation, were presented at one moment for encashment in gold. But such a contingency is just as likely as a general run on all the banks and currency offices. The only security against such a panic is that no such demand for conversion is ever likely to be made.³ The masses, the majority of whom are poor, will find the rupee useful as the rupee; it is the thoughtful and the speculative people who will demand gold for rupees. The only way to establish the confidence of the latter is to meet their demand boldly.

The danger is rather the other way. A 'convertible rupee', being small in its denomination, is no *adequate* safeguard against inflation; for, as the older economists clearly showed, the *de facto* suspended convertibility of the small note makes it practically

¹ See Leonard Darwin's evidence.

² Mr. Farrer.

³ See Mr. Farrer's evidence before the Fowler Committee.

inconvertible, and its over-issue is just as likely as that of inconvertible paper. A *limit* must therefore be placed on the issue of rupees and small notes, even when they are legally convertible into gold bullion. The currency in India should be allowed to expand annually by only a certain small percentage, representing its normal rate of progress in business. Beyond that percentage, Government should have no power to increase the currency, whether there is stringency in the money-market or not. It is no business of Government to respond to every gust of the wind that blows in the money-markets of the country.

9. Any scheme of 'a convertible rupee' implies the location of our gold reserves in India. We have already noticed that the Babington Smith Committee recommended that both silver and gold in the Paper Currency Reserve should be kept in India. What remains to be done is to transfer to India the greater part of our Gold Standard Reserve also, and hold it for the most part in actual gold. This does not imply that India should have no credits abroad. For, so long as India has to pay Home charges, and her balance of trade is at the mercy of rains, it would be wise to keep a certain amount of our resources abroad to mitigate the hardships of an occasional adverse exchange. But considerations of this kind do not justify the wasteful practice of keeping a large gold reserve abroad that is very rarely drawn upon. At any rate it is unthinkable that it can be allowed to continue under a system of 'convertible rupees', for we shall then need all the gold we can accumulate as a reserve for the encashment of our rupees in India.

Even apart from any such scheme of convertibility, adequate reasons exist for the transfer of our gold reserve to India. In the first place, Great Britain's gold reserves have been for many years notoriously slender almost to the verge of danger; and it is a gratuitous 'tempting of Providence' (to use the language of Sir Montagu Webb) to place India's gold reserves almost entirely in London in such circumstances. In the second place, 'owing to economic or political complications, there are two sets of complications conceivable in England that would make it an impossibility for India to withdraw her gold reserve from London, no matter how badly India might require it; and those are: (1) a panic in England arising out of an economic crisis; and (2) a financial crisis arising out of Great Britain's being involved in war

with a first-class Power.'¹ Thirdly, even from the narrow point of view of exchange stability, the automatic working of natural forces is impeded rather than helped by the present practice. Between countries using the same currency for their foreign trade, these natural forces depend for their working on the export of currency from one country to another, tending to raise the rate of interest in the exporting country, and to lower it in the importing country, and thus turning the current back in the other direction.² In the existing circumstances, the London money-market is apt to treat India's gold reserves as a part of the general gold reserves in London and to depend upon it for support in emergencies. The result is that even the sale of Reverse Councils, which is India's substitute for exporting gold, does not ease the English money-market as readily as actual export of gold from India would.

10. A wise Government would resort to various other supplementary measures by way of reform. It would in the first place decrease its gold obligations abroad, as these are a constant source of embarrassment. The Herschell Committee recommended this course as a measure supplementary to the closing of the mints; and the Fowler Committee considered it eminently desirable that 'the Government of India should husband the resources at their command, exercise a resolute economy, and *restrict the growth of their gold obligations*' for the speedy attainment of an *effective gold standard*. And yet this authoritative advice has been so far treated with supreme indifference.

Secondly, Government would do well to make an effort to accumulate a large stock of gold by adopting some of the methods formerly employed by the Russian Government when they set themselves resolutely to the task of establishing in Russia a gold standard without gold currency in circulation. They kept Russian gold production inside the country, raised the Russian rate of discount to a level higher than the one prevailing in the neighbouring countries, made the import duties payable in gold or gold equivalent, and took full advantage of the occasions when Russia had a favourable balance of trade by

¹ See Sir M. Webb's Memorandum before the Chamberlain Commission.

² See Mr. Darcy Lindsay's cross-examination by the Fowler Committee (Q. 3829-3834).

becoming large buyers of its export bills and ordering gold to be sent to them from the proceeds of such bills.¹

Thirdly, Government ought to simplify matters by amalgamating the Paper Currency Reserve and the Gold Standard Reserve, as was suggested by Mr. F. C. Harrison to the Chamberlain Commission. It is worth while noting the evidence of this witness on this point :—

Q. 10277. (Chairman) Let us revert to the Indian case. I had asked you to give us your views as regards the two reserves generally?—Yes. For a long time I have been wanting to suggest to the Government of India—but having left India now one's interest has waned a little—that it would be worth considering the question of amalgamating our currency note system and our ordinary currency system. At present our rupee is really a note printed in silver and our note is a note printed in paper. We are undertaking the liability to preserve the whole on a parity with gold at 1s. 4d. By way of taking a figure as an illustration, supposing we will say there are 180 crores of silver in circulation and 60 crores of notes in circulation. I should be rather inclined to look at the question: how much gold should we hold against the two together, against the 180 crores in silver notes and 60 crores in paper notes; and do away with the Gold Standard Reserve. To take a figure by way of illustration, say that we hold 25 crores of gold against the 180 crores of silver, and say we hold 15 crores of gold against the 60 crores of notes, . . . that would be 40 crores. Then what I would suggest is some plan of this kind: for every rupee we issue we keep the same proportion of gold, 25 to 180, or whatever is fixed, and similarly for whatever notes we issue we keep the same proportion of gold, i.e. 15 to 60. That is the sort of system I would prefer, I think, to see introduced by the Government of India. . . .

Q. 10280. Am I to understand that your view of the Gold Standard Reserve is that it should be regulated on the same principles on which you regulate, say, the stock of gold which you hold for encashment on bank-notes here?—Yes, I would let it stand simply on its own feet—that India has enough gold to back its silver and notes. . . .

¹ See Rothschild's evidence before the Fowler Committee (*Q.* 7613),

Q. 10283. (Mr. Keynes) Are you advocating that gold should be kept for the redemption of rupees when the gold is not wanted for export at all, and there is no unfavourable balance of trade?—Yes, I was saying that I should treat the rupee as exactly in the same position as the currency note. It is a note which is printed in silver.

Q. 10284. Is not that a purely wasteful practice, and of no use to anybody?—No, I think not, because there is the danger in having 180 crores of rupees current at a value in excess of their intrinsic value.

Q. 10285. Apart from the question of an adverse balance of trade and the exchanges, is there?—Yes.

Q. 10287. You do not think that gold is only wanted for the purposes of export?—No. Assuming you have certain counters which produce a certain price between the counters and the commodities, if there is a change in prices due to change in methods of business or a rise in the value of gold, you will require less of those counters. If those counters are bone you cannot reduce them. I mean if the counters are of no intrinsic value you cannot reduce them; they have a tendency to stick. You cannot reduce token currency, in other words, in the way that you can reduce a full value currency, which goes away until a near equilibrium is established.

Q. 10288. If you redeem rupees for sovereigns and the sovereigns are kept in the country and not exported, the volume of currency is exactly the same as it was previously?—Yes.

Q. 10289. Therefore there is no effect on prices?—But they may present more counters than you have gold behind. My point is that a full value currency seeks its own level, but a token currency cannot be contracted.

Lastly, Government should bring the Indian system into line with other systems by establishing a real State bank in India. Apart from the reasons noticed in chapter iv, a currency system of the kind recommended in this section can be worked by a central bank far more efficiently than by a Government department.

11. It must not be imagined that the scheme outlined above will give us as stable a monetary standard as Dr. Fisher's plan. All that is claimed for it is that it will be much more stable than the present rupee; that it will give the country the much-needed relief from the intolerable burden of high prices; and that it will

be much more economical than 'a gold standard with gold currency in internal circulation.' Like all other forms of gold standard, it will make for a *fall* of prices; but that fall will be much less than will follow the establishment of a gold standard with gold currency in active circulation.

But even this halfway house is not practicable till normal conditions are restored in some measure. A Government that finds its budget unbalanced every now and then, and has to finance its deficits by currency inflation and floating debt, must first put its house in order before embarking on any scheme of currency reform. It will not be easy for it under the present conditions to convert without heavy loss our sterling securities into gold. It would be simply playing into the hands of speculators in gold if it were to declare the rupee convertible into 1s. 4d. gold immediately. The world's conditions are in many ways unsettled. Although the sterling is approaching its pre-war parity with gold, we cannot take for granted the re-establishment of an effective gold standard in England in the immediate future, until we see what happens when England pays off its debt to the United States and can judge more clearly the future trend of prices there. An independent return to the gold standard under the present conditions has been found to be both impracticable and undesirable, even by gold-producing and gold-exporting countries like Australia and South Africa. It is extremely difficult if not impossible for any single country to maintain a gold standard amid all the vicissitudes of post-war trade and the incalculable possibilities of heavy inter-Government payments. For the exchange effects of large international payments are not confined merely to the countries immediately concerned. For instance, during the last few years the difficulties of France in meeting American claims served to depreciate the sterling-dollar exchange. As the dollar price of the franc fell, Frenchmen found it more profitable temporarily to pay their obligations through the medium of sterling; this sent up the sterling in terms of francs but down in terms of dollars. In these circumstances, 'the country which first returns to a gold standard, in effect places its gold reserves at the disposal of any country which has large obligations to discharge in the United States',¹

¹ See *Economic Journal*, July, 1922.

unless its balance of payments is relatively as favourable as that of the United States. The only suitable policy, at this juncture, then, is to 'wait and see'. This necessarily implies that natural forces should be allowed to work without hindrance. Government must not sell Council Bills beyond the requirements of the Secretary of State; it must allow deflation to take place. Stringency or no stringency, it is no part of Government's business to play godfather to the export trade and supply them with Indian currency at cheap rates. A general fall of prices in the world appears almost inevitable; and, unless the price-level in India is allowed to fall considerably, even exchange stability would be seriously jeopardized by the continuance of the present policy of selling Council Drafts. There is no justification whatever for the efforts that Government is making to prevent a *rise* in exchange. At any rate it is inconsistent with the official pronouncements that Government proposes to allow natural forces to work out their full effects.

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